S. HRG. 100-274

VENICE ECONOMIC SUMMIT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDREDTH CONGRESS

FIRST SESSION

APRIL 28, 1987

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

76-902 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J841-34

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[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

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VENICE ECONOMIC SUMMIT

TUESDAY, APRIL 28, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Proxmire, and Melcher; and Representative Solarz.

Also present: Judith Davison, executive director; Richard F. Kaufman, general counsel; Stephen Quick, chief economist; and William R. Buechner and John Starrels, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order. The subject of today's hearing is "Setting an Agenda for the Venice Economic Summit." The hearing will provide an opportunity for a number of recognized authorities on international economic matters to offer their views on what major issues face the world economy today and what major actions the leading nations should be considering to deal with these issues.

There's obviously a growing recognition that we live in an increasingly interconnected world economy, an economy in which the prosperity of individual nations and their citizens is closely related to the overall health and growth of the world economy. At the same time, there is also an increasing recognition that the world economy is undergoing a number of major strains which place the future health of that economy at risk.

In its most recent World Economic Outlook, the IMF took note of many of these potential problems, and on the strength of this review revised downward its estimate of industrial country growth for 1987. According to the most recent IMF projections, output in the industrialized world will rise only a sluggish 2.25 percent in 1987, down from an already disappointing 2.4 percent in 1986.

Slowing of growth in the industrialized world inevitably is a major concern to economic policymakers, for this slowdown aggravates the economic tensions in the worldwide economy. To take only two examples, trade frictions between nations increase when markets are growing slowly, and the Third World debt crisis becomes substantially more difficult to manage if debtor countries cannot find adequate markets for their exports.

Against this background of heightened tension and uncertainty, the upcoming Venice economic summit takes on particular importance. Summits bring together the leaders of the world's great economic powers to confront the problems of the world economic system. Given their critical role, the leading powers bear special responsibilities for contributing to the growth of the world economy as a whole. These responsibilities must be shared, and negotiations toward that end should be a high priority of international economic diplomacy.

At the same time, there is a growing awareness of the need for the major industrialized nations to coordinate their macroeconomic policies more closely, to prevent the emergence and persistence of major imbalances in world trade and finance. It is far easier, however, to endorse the broad concept of policy coordination than to develop explicit measures and mechanisms that will make effective coordination a reality.

Today's hearing offers an opportunity to explore these and other issues facing the world economy at this critical juncture. We are very pleased to have with us three recognized authorities on international economics: Stephen Marris, senior fellow at the Institute for International Economics and former chief economist for the OECD; Professor Jeffrey Sachs of Harvard University; and Ralph Bryant, senior fellow in economic studies at the Brookings Institution.

Gentlemen, we look forward to hearing your views on the issues confronting the international economy and your suggestions for an appropriate U.S. agenda for the upcoming Venice economic summit.

With that, I think we will proceed. We will take all of the testimony first and then have questions. And, Mr. Marris, why don't we start with you and then we will just move right across the panel to Professor Sachs and Mr. Bryant.

STATEMENT OF STEPHEN MARRIS, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. MARRIS. Well, as you said, Mr. Chairman, the Venice summit is going to take place at a difficult juncture in the world economy and, indeed, it seems to me that the most important issue at the Venice summit should be the fragile state of the world economy that you have already referred to.

To me, there have been four omnious recent developments.

First of all, in 1985 and 1986, the world's private sector lent to the United States over $100 billion each year to finance its massive trade and current account deficits. Although we haven't yet received all the figures, it appears pretty certain that that private inflow of capital dried up in the first quarter of this year. In other words, it was the world's central banks, including the Fed, that had to intervene on a massive scale to support the dollar, to the tune of perhaps—we don't know yet, but it looks as though it could easily have been $40 billion so far this year.

Now despite this massive intervention, U.S. interest rates have risen by as much as 150 basis points at the long end. And I believe that before long the central banks could well find that they are not

only having to finance the continuing large trade and current account deficit, but also rising outflows of private capital. That was in fact what happened in 1977 and 1978, and I think that that is quite likely what is in fact happening right now in the month of April.

How long the central banks' nerves will hold as total intervention piles up and reaches the $100 billion mark and goes on beyond that, is a very open question. The important point is that increasing doubts in the markets about the willingness or ability of the central banks to intervene on this scale will put further upward pressure on U.S. interest rates.

The second ominous development is that we knew from the start that correction of the U.S. trade deficit would have a strong negative impact on growth in other countries as they found that they were exporting less and importing more. According to my calculations, if we add in the indirect effects, this could well depress GNP output in Japan and Europe by 4 or 5 percentage points over the next 3 years.

Now the ominous thing is that growth in Japan and Europe has already slowed down sharply before there has been any significant improvement in the U.S. trade balance. They have already been hit by the collapse of their markets in the OPEC countries. They are also being hit by the fact that the developing countries' earnings from nonoil commodity exports have been going down and since those countries are financially strapped they simply had to cut back their imports as well.

So even before the necessary correction of the U.S. trade deficit has started on any significant scale their growth has slowed down. As you remarked, the IMF has had to substantially reduce its forecast for growth this year.

The third point is that the combination of slowing growth in the industrialized countries, weak commodity prices, and rising U.S. interest rates has already had an adverse impact on the developing countries and quite frankly, if those three things were to continue, then a new debt crisis will become inevitable with obviously serious consequences for both the debtor countries and for the U.S. banking system.

Finally, the fourth thing that I find very ominous is that frustration with slow progress in reducing the U.S. trade deficit has obviously fueled protectionist sentiment in Congress, and there are things going on today on the Hill which are evidence of that. But protectionist action is only likely to further erode the confidence of foreign and domestic investors in dollar denominated assets, as we saw very clearly when Wall Street went down after the announcement of the U.S. trade sanctions against Japan.

In a nutshell, both the dollar and the world economy are very much on track for the "hard landing" that I first predicted over 3 years ago. To quote from an article published then in Fortune Magazine, what I said was: "The point most Americans seem to miss is that when capital begins to flow out"—and I should have said when it ceases to flow in—"U.S. interest rates will rise. And as the dollar goes down, inflation will accelerate. In this climate, how will the market react to news of continuing large Treasury offerings? Won't fears about large budget deficits be reignited? It is precisely

this interaction of self-feeding doubt between domestic money markets and the foreign exchange markets that has been the most striking feature of what I call stabilization crises in other countries. What happens next? Again, the record from other countries is clear. As the dollar goes down, automakers and other industries exposed to world competition will cheer—and we've been hearing at least some faint cheers—but as the decline accelerates and Wall Street gets increasingly worried about inflation, budget deficits, and rising interests rates, the Fed will have no option but to keep a tight rein."

Well, that's what I said 3 years ago. Americans are no longer missing the point, at least on Wall Street, and this it seems to me to be roughly the situation we have to now.

I went on to say: "As the crisis develops, the painful and drawn-out process of cutting the budget deficit will have to get underway in earnest. And it could well be that the administration would find that it had itself into the same fix as my own country, Britain, in 1981; that in order to restore confidence in the markets, restrictive monetary and fiscal action has to be taken on a scale that is bound to generate or aggravate a recession."

Regrettably, Mr. Chairman, I believe that this is now the unpleasant prospect that is facing the Federal Reserve Board, Congress and the administration before the end of this year.

Here in Washington, the budget deficit chickens are coming home to roost. So long as foreigners were prepared to finance a large part of the deficit, there was no problem. Now they are not and the central banks have taken over. Effectively, that is to say it is the central banks of the world which are now financing the U.S. budget deficit by money creation.

But this intervention by itself cannot stem the dollar's decline in the absence of more basic changes in policies. Interest rates could well, according to my calculations, rise by as much as 500 basis points. In other words, now that the supply of foreign private savings has dried up, the budget deficit will start to "crowd out" interest sensitive private demand here in the United States—that is to say, housing, construction, plant and equipment, and consumer durables—and a recession will become unavoidable.

In Japan and Europe, the chickens are also coming home to roost. During the first half of the 1980's one-half of their growth came, directly or indirectly, not from their own domestic demand, but from external demand, largely from the United States.

To give you just one example, in Germany, domestic demand between 1980 and 1985 only rose by 1.5 percent. That's over a whole 5 years, it only rose by 1.5 percent. GNP over those 5 years rose by 5.5 percent, which wasn't particularly good—far less than in this country—and there was a sharp rise in unemployment. But the important point is that four-fifths of that increase in output came from external demand.

Now external demand has turned negative and is likely to remain negative in Europe and Japan for several years. So it is now up to them to provide the stimulus needed to avoid a world recession while the United States is putting its house in order. They could do it. After all, the combined GNP of Europe and Japan is 50 percent greater than that of the United States. They, there-

fore, have economic weight sufficient in fact to carry the world economy through this difficult period. But whether they will do so is at the moment very much open to doubt.

So let me now suggest a package deal for the Venice summit. The one essential thing that President Reagan should take with him to Venice is a willingness to tell his colleagues that, on certain conditions, he is willing to give his personal support to a fiscal year 1988 budget, worked out with Congress, that genuinely cuts the deficit by at least $40 billion—I would prefer $50 billion—and includes at least $20 billion of tax increases. The President should also be prepared to acknowledge that similar packages, combining both expenditure cuts and tax increases, will be needed in fiscal year 1989 and subsequent years.

Now the President will hardly need to tell his colleagues that this was a very painful decision on his part, going against his deeply held and oft-repeated principles, for which he would no doubt pay a significant political price. He would thus be in a strong position to insist on his conditions. Given the weak state of the world economy, he should announce that he would not be willing to give his approval to such a budget unless and until Japan and Europe had put into effect expansionary fiscal packages more than sufficient to offset the restrictive action being taken by the United States.

It is probable, of course, that Prime Minister Nakasone will take with him to Venice his recently announced $35 billion program of fiscal expansion, which he no doubt brought with him to Washington today. But President Reagan would do well to treat this with considerable suspicion. After all, two such packages were already announced last year and disappeared more or less without a trace. A genuine package of this magnitude for Japan would, moreover, have to involve substantial tax cuts, as well as accelerated public investment, and would thus involve overcoming intense opposition from the all-powerful Ministry of Finance. As for President Reagan, there would also be a heavy political price to pay. Prime Minister Nakasone and the Liberal Democratic Party would have to abandon, at least temporarily, their plans for what they call "fiscal consolidation" in which they have invested almost as much political capital as President Reagan has in his view that taxes should not be increased.

I suspect that the Germans would probably be even more recalcitrant. The President should ask them for a program of fiscal expansion of at least $25 billion to be brought into effect before the end of this year. Again, any proposals they put forward should be examined with care. The so-called "tax cuts" in Germany in January 1986 and planned for January 1988 and January 1990 are to some extent an illusion. The German income and corporate tax rates are not indexed in any way, so that given the nature of the German tax system, regular tax "cuts" have to be made simply in order to prevent the tax burden from rising. Having just won an election, the German Government is well placed to take this necessary action. But it also has committed a great deal of political capital to fiscal consolidation and it is hard to see how such a program could be carried through by the present Minister of Finance, Herr

Stoltenberg, who has committed himself personally and very publicly to further reductions in the budget deficit.

There could and should be other elements in the overall package. U.S. trade sanctions against Japan should be lifted, with suitable trade concessions from the Japanese side. If the Japanese bring forward their proposal to provide $30 billion of financing to Latin America, this should be warmly welcomed, so long as it is being offered in addition to a large domestic fiscal package. Other action to help the debtor developing countries should also be considered, including I would hope U.S. agreement to proposals by Britain and France for alleviating the debt burden in Africa. And if possible, a strong additional impetus should be given to the negotiations, particularly on agriculture, in the framework of the Uruguay Round in the GATT. But all of this, quite frankly, pales into insignificance compared with the necessary monetary and fiscal action needed to stave off the impending world recession.

No doubt the most obvious obstacle to a package deal of this kind is President Reagan himself. But, as argued above, eroding confidence in the dollar and in the U.S. financial markets is likely to lead to a recession in this country next year. This will not only tarnish the President's image, but would also probably ensure the election of a Democrat in 1988. Unfortunately, it is possible that the Venice meeting may be in one sense coming a bit too soon. The markets may not have "spoken" clearly enough by then for the President to have received the message. It is, therefore, to be hoped that in the short time remaining the President's closest advisers, including perhaps particularly his Chief of Staff, can persuade him that the economic and political stakes are now getting very high, that the promise of what would actually be a relatively small tax increase at the Venice summit could possibly break the present deadlock in international economic cooperation, and that if he misses this opportunity there may not be another.

To be honest, Mr. Chairman, I should say that I am not very optimistic that the right decisions will be taken at the Venice summit, so to end on a sales pitch, if you want to know what's going to happen next, I suggest you buy a copy of my book in which I have set it out in great detail, the last chapter of which is called "How To Make Constructive Use of the Crisis."

Senator SARBANES. Thank you very much. Professor Sachs, please proceed.

STATEMENT OF JEFFREY SACHS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. SACHS. Thank you very much, Mr. Chairman. Thank you for the opportunity to testify. It's a pleasure for me to follow Mr. Marris, who has been one of my fondest teachers in this matter for many years, and he has been one of the most prescient observers of the developments in the international economy. Not surprisingly for me, I agree with very much of what he has to say, so we are going to have the reverse spectacle of at least two economists agreeing on most things, and I think when Ralph Bryant testifies we will see that three of us agree.

There are some points of emphasis where I do differ and I will try to spell those out in my own testimony.

Let me underline what the main points of agreement are. I think the first and key point of agreement is that what we are observing in the world economy today is indeed the U.S. budget deficits coming home to roost. Whether it's the dollar, whether it's the trade balance, whether it's the frictions with our partners, this is the unwinding or the continuing winding out of the story that began with the huge fiscal imbalances in the United States and the present stalemate in international policy, in my view, as I think with Mr. Marris, is tied very keenly to President Reagan's continued resistance to acknowledge the need for tax increases.

I agree in my own prepared statement—I'll quote myself just to underline that we both put absolute centrality on this point—I wrote that "Without doubt, there is a single step that could be taken that would vastly improve the outlook of the world economy. The Reagan administration could acknowledge the need for some tax increases as a step to reducing the U.S. budget and trade deficits. Such an acknowledgment would have profound effects.

"It would convince the other nations and the world capital markets that the United States is seriously on the path of addressing its real problems. It would prompt a fall in long-term interest rates around the world. It would banish much of the momentum of protectionism, since a more realistic path for reduced trade deficits would come into sight. It would enable other governments, especially Japan, to bargain far more seriously with the United States, by reducing the greatest source of uncertainty in the world economy, and the greatest source of skepticism in the rest of the world about the quality of the United States economic leadership. Japan and Germany would readily agree to more expansionary policies of their own were they convinced that the United States budget deficit was being decisively reduced. Japan could far more seriously begin the implementation of the Mayakawa recommendations.

"But such an acknowledgment is almost surely not going to happen until the Economic Summit of June 1989." I am extremely skeptical that we have reached that point politically, but I think that we agree that centrally the problems of the present policy stalemate in the world are grounded in the United States. The central problems have started here, our failure to recognize that makes it extremely difficult for us to talk seriously with our partners on a whole range of issues because we inevitably have to glide over the most important element in the world economic situation.

Like Mr. Marris who didn't mention trade policy abroad at all, I also do not regard that trade actions abroad as a major element of the present imbalances in the world economy. I think also by the absence of Mr. Marris' statement about the dollar, the strategy of talking the dollar down in the past year and underlining that with expansionary monetary policy in the United States has not, cannot, and will not work to reduce the trade deficit by itself. It must come in conjunction with fiscal retrenchment in the United States.

So it is an inflationary policy and one that cannot be successful in the absence of more fundamental fiscal changes in the United States.

Finally, I noted the absence in his remarks and in mine also of a discussion about the need to stabilize exchange rates or to have major international monetary reform at the present time. It's just not timely to move on new coordinated monetary exchange rate arrangements with the present huge trade imbalances still unresolved and with the fiscal developments in the various countries being so diametrically opposed.

Let me point out the areas of emphasis where we would differ and also I will speak to one point that Mr. Marris did not address in detail.

I think that the notion that United States fiscal retrenchment when it comes should be balanced by fiscal expansion abroad is a great exaggeration of what's needed. It is the notion that there must be some conservation in the world economy of bad economic behavior and that once we tighten up and start getting our own budget deficits in line then someone else has to behave badly or the world economy is going to fall apart.

There are at least two policy instruments that we have available. We have fiscal policies and monetary policies as two ways to stimulate an economy, and I would say that the central problems in Europe and Japan right now are not so much their lack of fiscal stimulus, but the fact that they have maintained too tight monetary policies in the current situation. And rather than moaning about the movement of the dollar, they could unilaterally relax the movement of the dollar not so much through sterilized foreign exchange intervention but just by greater open market intervention and more rapid growth of the money supply in Germany and Japan. And that policy would be highly successful, in my view, in stimulating the domestic parts of their economy, getting higher investment spending and higher private sector spending, as opposed to higher Government spending.

In other words, to balance the contraction of U.S. fiscal policy when and if it ever comes—this may be an academic point—what Japan and Germany and the rest of the OECD can do and I think should do in major proportion is to ease monetary policies sufficiently so that the private spending in those economies substitutes for the export-led growth that they have been enjoying because of large U.S. fiscal deficits.

In our position, to advocate large fiscal deficit increases abroad simply won't wash. It's politically a nonstarter, I believe, and for good reason. The other countries have seen what an incredible mess the United States has acquired with this kind of policy and they know themselves that fiscal expansions are extremely difficult to reverse and I am quite convinced that however hard we pound the table we won't get more than 1 percent of GNP out of Japan in terms of higher spending, at most, and I think that the skepticism that Mr. Marris expressed about the new policy package is well taken. The Japanese recognize that their long-run interest is tight fiscal policy, particularly since they, as in the United States, have had an enormous runup in internal debt in the last 10 years, and they are simply not interested in getting into the same kind of morass that we find ourselves in.

Thankfully, the world does not turn on fiscal expansion and it's not the only way to maintain high employment in the economy.

For countries that have falling price levels, huge external surpluses, and falling output, there is no reason in the world why they should not have more expansionary monetary policy. And that's the kind of policy instrument that can be turned off. It's not expensive to use. And it is one that is subject to reversal.

That's the one that we should make clear that we are most interested in them pursuing. That would have the beneficial effect of having that expansion abroad take place in the context of falling world interest rates rather than in the context of rising world interest rates, which is what a fiscal expansion in Germany and Japan would provoke. So that's one area where I think there's some disagreement.

Quantitatively, perhaps, our disagreement isn't so fundamental. I don't think great problems would arise for Japan and for Germany if they had a 1 percent of GNP fiscal expansion, for instance. On the other hand, we shouldn't fool ourselves that that's going to do anything for the U.S. economy.

Every single model of the international economy that examines that degree of interdependence shows that if Japan has a 1 percent of GNP higher deficit or Germany does, we don't get anything in the United States and we will continue pounding the table for 2, 3, or 4 percent, and simply it's not going to be a feasible path to follow in the longer term.

A second point that I would like to mention is that there has been increasing talk in this town at least of bashing the East Asian NIC's as another way to stimulate our economy and improve the trade balance, particularly Korea, Taiwan, Singapore, and Hong Kong. This in my mind is also an extremely pernicious and unwise policy for us.

We have much greater interest in these countries than telling them how to manage what are still fragile economies, particularly a country like Korea with a $45 billion external debt, and given our overall strategic interest in that country and given its political difficulties, for us to be leaning on them to do what again would show up in the fourth decimal place in our own economy in effect is simply flying off at the handle without any serious analysis at all. And I know that this seems to be on the agenda in Venice, to call for the nonparticipants also to increase spending, and I think this is just a bit of rhetoric that we ought to get off because it has absolutely no economic significance or seriousness in my mind. It does nothing for U.S. problems.

I think there has been a very positive development recently, or at least potentially positive development, if we seize on it. And that was the announcement last week by the Japanese Foreign Minister of the intention of Japan to increase lending to Latin America.

In my prepared statement, I go on for a few pages about that because I think this is potentially very important. It's important for a couple of reasons.

One reason that is crucial is the following: Every dollar that Japan lends to Latin America instead of lending to its own Government for a larger fiscal deficit, will have a more beneficial effect on the United States. In other words, 1 percent of Japanese GNP increase in lending to Latin America will be more expansionary for

us than a 1 percent of GNP increase in the Government deficit in Japan.

The reason is quite simple. Whether Japanese savers lend to their Government for spending or whether they lend to Brazil for spending, in both cases there is going to be a rise in spending in the world. But since the Latin Americans have a higher propensity to consume U.S. goods than the Japanese economy does, on average, if the money is lent to Latin America rather than to the Japanese Government, we are going to be greater beneficiaries in terms of exports and in terms of economic growth in the United States.

So this seems to me to be a potentially very fruitful policy initiative and one that we should latch onto immediately and try to build up into something of real economic significance. If you remember, the Foreign Minister last week first announced $30 billion in this program without specifying the time horizon, and then that was clarified down to $20 billion over 3 years, and then back in Japan, $20 billion over 5 years. The cat is out of the bag. We should make sure it doesn't get put back in. We should now grab on and try to build up this number as large as possible because this is better for us than all the fiscal expansion that they don't want to do. It's a way that the Japanese can continue to save as they want to, and we can get the expansion that we want to. It's just that the money would be put to much better use.

Now most economists that have analyzed the situation in Latin America or for the Baker 15 debtor countries feel that for growth to be restored to that region the increase in capital inflows required is on the order of $20 to $30 billion a year. And I think that that is the scale of program that we should be calling for and trying to build into this new proposal. It seems to me an extremely feasible scale, if done right. It was one that would have true macroeconomic significance for the United States.

According to my own simulation estimates, it would improve U.S. exports by about $15 billion per year if such a program were put into place by stimulating increased demand in Latin America.

In the prepared statement I discuss some of the recommendations of how to implement such a program. The key is that the Japanese savers as they invest in Latin America would have to get a financial claim on the Latin Americans that would supersede the present claims that the commercial banks have. In other words, the new debts or the new instruments would have to be senior instruments to the commercial bank debt. And one of the things that our Government should be doing is to try to design a financial scheme—and some are suggested in the paper—in which that kind of superior debt instrument can be created to increase the flow of Japanese savings to Latin America in an amount that would have substantial benefit for the Latin American countries and would do more for U.S. exports than a similar size expansion in Japan.

It also strikes me that such a proposal is not a substitute for the kind of debt relief proposal that you, Mr. Chairman, have been sponsoring but, rather, is a natural accompaniment of such a proposal. Combining increased net inflows with write-down of old debt is exactly what a chapter XI proceeding does and that's exactly what we ought to be looking for for the Latin American countries. Getting some of the old bank debt down, getting some of the new

debt in on a senior basis to the old debt, and doing that write-down in the form of international buy-backs by the World Bank or other newly created financial intermediary. This again seems to me to be a high priority for U.S. discussion, not only to relieve the debt crisis, but recognizing that the fiscal expansion that comes out of that and the export expansion is going to be greater proportionately than all of the benefits that we would get out of an increase in Japanese fiscal deficits, which I believe will not come in any event.

Let me make one final point as an observer of the summit process for several years and the G–5, G–7, G–3, and G–2 process in the past couple of years.

These are not serious exercises, I think almost any professional observer has to conclude. These are exercises of remarkable superficiality in terms of analysis and in terms of depth of discussion. I am not expecting miracles from the discussion of the heads of state on technical economics issues, but at least when the finance ministers get together as they do at the Plaza or at the Louvre or as they prepare for the summit, one can expect far more than what we've gotten from this Government or the Japanese Government and the German Government in the form of policy discussion and policy analysis.

I happened to be in Japan for several months in the past year and watched closely as the Japanese representatives went off to one of these meetings without any technical analysis whatsoever. And it was explained to me that that was okay because the Americans didn't have any technical analysis either.

For the last 2 years, the Secretary of the Treasury has been demanding this action or that action from Japan or from Germany, pounding the table for an expansion of this sort or a monetary this or a debt this or a fiscal this, without ever seriously analyzing for one moment what the quantitative implications would be for the Japanese economy and for the U.S. economy.

Now scenario building is not a precise science and one can't get firm estimates for a lot of the things that we are greatly concerned about, but it still behooves us as serious participants in the world economy and erstwhile leaders of the world economy I would say to do a little bit better than just making demands without any quantification whatsoever.

If one did start the process of quantification, we would learn several things. First, for example, all of the econometric models of the world economy, as imperfect as they are, show that Japanese fiscal expansion of any reasonable magnitude are not going to make a great deal of difference for the U.S. trade deficit. It simply can't be done—or can't be demonstrated with any of the technical analyses that have been prepared to date. This is something that should be known.

What is Secretary Baker really talking about? Well, if you actually look at it, we can't get more than a few billion dollars over what we're spilling blood to accomplish on most things. And this is a very important point.

Similarly, almost every econometric model, had the Secretary taken the time to look, with all due respect, has shown that talking down the dollar cannot make a significant difference to trade balances without accompanying fiscal actions. It turns out that in

about half of the leading models in the world depreciations of the dollar through monetary expansion, as we've had in the United States in the past year, actually worsened the trade deficit because while they stimulate exports, they stimulate imports just the same and even in larger amounts.

So what I stress at the end of the prepared statement is that we're going to be in this process for a long time and it seems to me that this is a good point to make clear that the process doesn't work right now, not only because of the political stalemate all around the world but because of a lack of seriousness in the way that this process has been approached to date. At a minimum, we should require that governments come to these meetings with forecasts, with multilaterial forecasts, and with policy scenarios. So that at least the Secretary of the Treasury can put on the table what the U.S. Government view is of what a Japanese expansion would do, how large is he talking about, what does he really believe the effects would be on the rest of the world.

Without that kind of serious dialog among the countries, we cannot make progress from the present point.

[The prepared statement of Mr. Sachs follows:]

PREPARED STATEMENT OF JEFFREY SACHS

The goal of the Venice Economic Summit in June 1987 should be clear. The leaders of the industrial nations should look for fiscal, monetary, and financial policies that are likely to maintain economic growth in their countries, and that at the same time ameliorate the serious trade and financial imbalances that now imperil the world economy. Finding such a set of policies is not as technically difficult as might be supposed. Nor is the political prospect for meliorative action altogether bleak, despite the continuing shambles of U.S. fiscal policy. The recent announcement of a Japanese initiative to lend $30 billion to the Latin American debtor countries is of broad potential benefit, much broader than is yet appreciated. The Reagan Administration should now work with Japan up to the time of the Venice Summit to get maximum benefits out of this new policy initiative.

The major short-run macroeconomic problems facing the U.S. and the world economy can be succinctly outlined.

- The United States trade imbalance continues unabated, despite a significant drop in the value of the dollar.
- Growth in Europe and Japan appears to be slowing, mostly because of the weakening of the dollar relative to the currencies of these nations;
- The Latin American debtor countries remain in desperate economic shape, with inflation over 100 percent per year in Argentina, Brazil, Mexico, and Peru, and with hopes for economic recovery fading in these countries, and

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in Ecuador, Venezuela, and the countries of Central America. The so-called Baker Plan is widely seen as nonexistent. Generally, the debt management strategy is unravelling.

- The debtor countries in Sub-Saharan Africa are in even more dire condition.

- Protectionist sentiment is growing rapidly along with the failure to resolve the U.S. trade imbalance.

The Reagan Administration response to these pressures has been inadequate because of its unwillingness to face realities in two areas: U.S. budget policy and U.S. management of the international debt crisis. The failure of the Administration to acknowledge the links between the trade deficit and the fiscal deficit, and to recognize the need for tax increases as a partial remedy for the trade imbalances has blocked a serious national and international response to the global imbalances. With regard to the debt crisis, the Administration continues to be far more concerned with guaranteeing U.S. bank profits than with restoring growth in Latin America, the kind of growth that could make a dent in our own trade deficit and definitively put the debt crisis behind us.

The overall macroeconomic strategy to pursue to overcome the global imbalances are not hard to see. They involve four major points.

- The U.S. trade deficit will improve mainly in line with reductions in the U.S. budget deficit. (A rise in private savings rates, or a decline in investment rates are the other two ways that the deficit could moderate.) Cutting the budget deficit is the only effective policy measure available for reducing the trade deficit;

• As the U.S. budget deficit is reduced, monetary policy in the U.S. and in Europe and Japan should be sufficiently expansionary to stimulate a rise in investment as a substitute for the declining stimulus from the U.S. fiscal deficits;

• The debtor countries will grow only with significant infusions of new capital, and with significant relief from the overhang of existing debt. New capital inflows into Latin America will significantly raise U.S. exports to the region.

• In the medium term, the Japanese economy must be restructured along the lines of the Maeyakawa Report to spur more privately generated domestic demand.

There are also three misconceptions about the current situation that must be set aside before a realistic program can be put in place. These are as follows. First, higher budget deficits in Europe and Japan are not the only way, or the most effective way, for those economies to spur growth at the present time. Easier monetary policies abroad can be used to make sure that the recent U.S. dollar depreciation does not create a slowdown in Europe and Japan. Second, a further depreciation of the U.S. dollar, in the absence of tighter fiscal policies in the U.S., will do little to restore trade balance in the U.S. This is especially true if the dollar decline is brought about by expansionary monetary policies in the U.S., as has been true in the past several months, since a monetary expansion tends to raise exports and imports at about the same rate. The dollar declines may raise domestic output and will tend to increase inflation, but will not greatly improve the trade and current account balances.

The third misconception is that the current U.S. strategy for managing the Latin American debt crisis is on track. The strategy, which has called for continued interest servicing by Latin America in return for modest amounts of new loans (much less than the interest payments), has failed on several counts: the debtor countries are not recovering; U.S. exports to the region are stagnant; frail democracies are challenged throughout the region; and the commercial banks have basically stopped new lending, except in a couple of celebrated cases. The irony is that the debtor countries could be given far more relief without jeopardizing the U.S. commercial banks. The continuing fear of a banking collapse is completely misplaced, and not to be put on par with the more realistic fear of economic or political collapse in Latin America. The most direct demonstration that the banks are crying wolf in the debt crisis is seen in Citicorp's recent decision to raise its dividend by 10 percent a few weeks after Brazil suspended interest payments on its debts. Some banking crisis!

In view of these observations, we can now suggest the range of policies that should be agreed to at the Economic Summit in Venice. Without doubt, there is a single step that could be taken that would vastly improve the outlook of the world economy. The Reagan administration could acknowledge the need for some tax increases as a step to reducing the U.S. budget and trade deficits. Such an acknowledgement would have profound effects. It would convince the other nations, and the world capital markets, that the U.S. is seriously on the path of addressing its real problems. It would prompt a fall in long-term interest rates around the world. It would banish much of the momentum of protectionism, since a more realistic path for reduced trade

deficits would come into sight. It would enable other governments, especially Japan, to bargain far more seriously with the U.S., by reducing the greatest source of uncertainty in the world economy, and the greatest source of skepticism in the rest of the world about the quality of U.S. economic leadership. Japan and Germany would readily agree to more expansionary policies of their own were they convinced that the U.S. budget deficit was being decisively reduced. Japan could far more seriously begin the implementation of the Maeyakawa recommendations.

But such an acknowledgement is almost surely not going to happen until the Economic Summit of June 1989. What then is best discussed in Venice? Given the likely stalemate over U.S. fiscal policy for the next year and one half, and therefore the limited gains on the U.S. trade deficit from changes in U.S. macroeconomic policy, the major aims for the industrial nations are: (1) to avoid a sharp slowdown in economic growth; (2) to avoid a outbreak of virulent protectionism; and (3) to prevent the debt crisis from further crippling the debtor countries, with the inevitable reverberations on the U.S. and world economy. Fortunately, the new Japanese proposal to channel new lending to Latin America can help to achieve all three aims in the short run.

Before turning to that proposal, let us consider the stance of monetary and fiscal policies in Europe and Japan more generally. Both Europe and Japan are reluctant to expand fiscal deficits to counteract their recent economic slowdown. This is for good reason, given the enormous political costs involved in reducing deficits later on, and given the enormous mess that arises when deficits are stuck too high, as in the U.S. The Reagan Administration should make clear that it is not pressing for significantly

larger budget deficits abroad. An increase in the Japanese budget deficit of 1 - 2 percent of GNP might make some sense for the Japanese, though it is likely to be of small consequence for the U.S. (raising U.S. exports by a mere $5-10 billion). We should understand that the Europeans and Japanese can more effectively maintain growth through somewhat more expansionary monetary policies, which are much easier to reverse when necessary in the future.

With respect to monetary policy the notion of stabilizing exchange rates through international agreements should be set aside for the near future, until the U.S. budgetary morass is resolved. We have now seen agreement after agreement on exchange rates fall by the wayside in a matter of weeks in the current economic conditions. The U.S. is not really prepared at this point to bind monetary policy according to live up to an exchange rate agreement (e.g. if the choice is between slower U.S. growth and a stable dollar), and the pretense to the contrary should be avoided. Also, until more progress is made on the fiscal deficit, we can have little confidence in our ability to assess the "equilibrium" value of the exchange rate that will be consistent with more balanced trade and budgets. Therefore, our best strategy is simply to press the monetary authorities abroad to maintain sufficient monetary ease to avoid an unnecessary slowdown in growth, especially since the inflation indicators in West Germany and Japan continue to be firmly under control (inflation has been negative in both countries in the most recent twelve-month period).

The best way to moderate the fall in the dollar in such circumstances is for the U.S. to abandon, explicitly, the notion that easy money and a weaker dollar, by themselves, are a key to restoring trade balance. Easier money and

dollar depreciation can improve the trade balance only in tandem with fiscal contraction. An acknowledgement of this point would allay much of the fears of the financial markets that the Fed is tied to easy money as a strategem for avoiding protectionism in Congress. Such a strategem would be doomed to fail, since the continued easy money would risk inflation without prompting much trade improvement.

Let us turn to the macroeconomics of the Japanese proposal to increase lending to Latin America. The current account surplus in Japan is now running at about $90 billion per year, or about 5 percent of Japanese GNP. This excess of Japanese savings over Japanese investment is now being used almost exclusively by the Japanese to finance the purchase of securities and equity ownership in the United States and Europe. The Reagan Administration has suggested repeatedly that U.S. exports and U.S. growth would be enhanced if the Japanese savings were used instead to finance larger Japanese government spending (or lower taxes) rather than purchases of foreign securities, and has thus urged a fiscal expansion as a way to stimulate the Japanese economy.

The channeling of Japanese savings to Latin America would have an even stronger expansionary effect on the U.S. economy than would an equivalent increase in Japanese government spending. Each $1 of incremental lending to Latin America would allow that credit-starved region to increase investment spending and imports by $1 dollar. On average, each $1 increase in imports would raise demand for U.S. exports by about 40 cents given the trade patterns in Latin America. On the other hand, if the savings are channeled into higher government spending in Japan, the Japanese government would spend most of the increase on domestic Japanese output in the first instance. This spending

would indirectly spur Japanese imports, but according to my estimates, only by about 20 cents per $1 increase in spending. The main point is that Japan's high savings do not have to finance larger Japanese budget deficits in order to raise U.S. exports, as is sometimes implied in the current macroeconomic policy debate with Japan. As long as the savings are used to finance greater imports from the U.S. market by third countries, the effect will be beneficial to the U.S. The surest way to finance higher imports from the U.S. market is to channel funds to credit-hungry buyers of U.S. products, rather than to the Japanese government. The Latin American debtor countries are the perfect targets for greater lending!

The advantages of this form of recycling are bountiful. If the money is lent in this way, world savings are channeled to the region most desperately in need of them. Rather than spurring a consumption boom in Japan, with little benefit for the world as a whole, investment spending in Latin America could be restored, with a major beneficial effect on the future of the region. The debt crisis would be greatly eased, and the Japanese desire to save for their own future would be protected. From the perspective of Japanese policymakers, the treasured policy of fiscal balance in Japan would not have to be overridden by running risky budget deficits to suit the demands of U.S. policymakers.

There are three major considerations that must be addressed to turn to the proposed Japanese policy into one of significant benefit to the world economy. First, the financial flow from Japan to Latin America must be organized in a way to protect the interest of the potential Japanese investors. In other words, the flow of funds to Latin America must represent

a sound investment for the Japanese savers in order for the proposal to work. Second, the increased lending by the Japanese should not serve merely to bail out the commercial banks with exposure in the region. If the banks are allowed to pull out scot free as the new Japanese loans come in, then the net benefits to Latin America and the U.S. will be gutted. Third, the size of the program must be large enough to be meaningful in the macroeconomic context. Let us consider each of these points in turn.

Most economists that have analyzed the macroeconomic situation in Latin America call for an increased net capital inflow into the region of at $20-$30 billion per year for the next five years, as the precondition for renewed growth of 4-5 percent per year in Latin America. But why would such an amount be lent by Japanese savers if the current stock of Latin American debt is already too large to service, and if the former bank lenders to the region are trying to get out? The key to inducing new lending is to give the new loans a priority status (i.e. seniority) over the existing bank loans. That is, the new incremental lenders should be guaranteed that their claims would be serviced and repaid with a priority over any repayments to the commercial banks. This kind of seniority already applies to the foreign bonds floated in the past by the Latin American countries. Such bonds have not been rescheduled and have been fully serviced in the past five years. Seniority also applies to the lending by the World Bank and the IMF, which receive full repayments on past loans from almost all of the debtor countries.

The requisite seniority could be achieved in several ways. First, the Japanese lending could be channeled through the World Bank as a financial intermediary. The Japanese private savers would get claims on the World Bank,

and the World Bank would hold the ultimate claims on the debtor countries. Alternatively, the new lending could be in the form of bonds, with the explicit legal understanding that the bonds would not be rescheduled. The commercial banks, which would benefit from the fact that new lenders would contribute to the financing of the region, could be required to acknowledge the seniority of the new lending through formal amendments of the existing loan agreements.

A major increase in Japanese lending to Latin America would raise the possibility for the banks to pull back their own new lending, and indeed to demand higher net repayments of debt. It is important that the new lending represent a net increase in funds to the region, rather than merely a mechanism for greater net repayments to the commercial banks. To make sure that the new loans actually increase the net flow of resources, the Japanese initiative should be combined with a mechanism for restructuring the existing bank debts, such as has been proposed by Senator Sarbanes and others. In the Sarbanes proposal, a new international financial intermediary, perhaps located at the IMF or World Bank, would repurchase the existing bank loans at a discount, and would pass along the savings to the debtor countries in the form of reduced interest rates, subject to appropriate adjustment policies in the debtor countries.

The Sarbanes proposal is a natural accompaniment of, rather than substitute for, the proposed Japanese initiative. Existing debts would be written down as new ones are contracted, as in a standard Chapter 11 proceeding. The problem of new loans going merely to bail out old loans would be avoided. The Latin Americans would get two forms of relief, and U.S. trade

and growth would be doubly benefitted. It cannot be overstressed that the commercial banks are well place to absorb the writedowns envisioned in the Sarbanes proposals. Commercial bank stocks have already been depressed by 30-40 cents per $1 claim on the major Latin debtor countries, in anticipation of future writeoffs of the debt. In this sense, the bank shareholders have already paid for the debt relief envisioned in the buyback schemes, without doing injury to the long-run solvency of the banks. This is why Citicorp could brazenly raise dividends in the face of the cutoff in Brazilian debt servicing.

The key to making the Japanese proposal a serious one is to make it large enough to have real effect. At first the Japanese Foreign Minister spoke of $30 billion in new lending. Later Japanese commentators have put the proposal at $20 billion spread over three years. With trade surpluses of $90 billion, this would amount to using less than 10 percent of the surplus each year for this purpose, a proportion that is surely inadequate. The Reagan Administration should work hard to make sure that the final number is on the order of $25 - $30 billion per year, enough to raise U.S. net exports by $10 - $12 billion per year. The list of eligible countries could be expanded to include debtor countries in other parts of the world, e.g., the Philippines. These new loans could be combined with interest rate relief via the debt buyback scheme on the order of another $7 billion per year, and new multilateral lending on the order of $5 billion per year. (Latin bank debt now totals around $200 billion. If three-fourths of the debt were repurchased at a price of $0.60 per $1, the interest flow relief would amount to about $6.6 billion per year). The total stimulus to U.S. exports would amount to

$15 - $17 billion per year. To achieve the larger number, the Japanese resource flows must be given sufficient guarantees along the lines that I have suggested. The Administration should see the Japanese proposal as an opportunity for redesigning the entire debt management strategy.

There is one remaining point that must be stressed regarding debt management. Many of the poorest nations in the world (the IDA-eligible countries) are suffering seriously with a heavy debt burden, mainly to official creditors. Such debt, particularly for the sub-Saharan African countries, is too small to be of serious global consequence, but is of punishing consequence for the debtor countries themselves. It is imperative as a matter of foreign aid that the leading industrial nations work out an arrangement for relief on offical credits, perhaps in the context of the Paris Club. An announcement at Venice of the intention to grant such relief would not do much to reduce global imbalances, but it would have a profound affect on the quality of life for tens of millions of impoverished individuals.

Let me now summarize the major conclusions for short-run macroeconomic policy coordination. The main missing piece in the global puzzle is a commitment by the U.S. to raise taxes as a part of fiscal retrenchment. In the absence of such a commitment, there will be relatively little serious progress on fundamental international policy coordination, and continuing skepticism about U.S. leadership in the world economy. Even in the absence of such a commitment, however, there are some areas where cooperation can be achieved.

With respect to fiscal policy, the U.S. is not well served by continuing to press Europe and Japan for significant increases in budget deficits. At

most, we should desire and expect fiscal increases in Germany and Japan on the order of 1 percent of GNP. Much more importantly, we should insist that monetary policies in these countries remain sufficiently expansionary to avoid a slowdown in growth, given the overall weak state of their economies, and given the very low levels of inflation. Consistent with monetary flexibility, however, is the abandonment of the quest for firmer exchange rate targets in the near future, at least until more fundamental progress is made on the fiscal front in the U.S. Moreover, the U.S. should recognize that continued easy monetary policy as a way to push the dollar down and thereby improve the trade balance is bound to fail. Dollar depreciation must be combined with fiscal contraction to have significant effect on the external deficit.

The Japanese proposal for recycling savings to Latin America should be strongly embraced, and actively developed into a major policy initiative. The amounts involved should be large, and the proposal should be couched in the context of more fundamental changes in the debt management strategy. The key here is to make the new Japanese savings sufficiently safe for it to proceed at a significant level. For that, the new lending should be senior to the existing bank loans, and the existing bank loans should be restructured along the lines of the Sarbanes proposal for a new international financial intermediary to repurchase the bank claims at a discount.

Let me conclude with an observation about the problems of longer term policy coordination. Observers of in the international policy discussions in recent years have been struck by the remarkable superficiality of the proceedings and the lack of serious analysis underlying the policy debate within the G-7. Part of this involves the peculiarities of national politics.

For example, our allies rarely never mention the obvious need for higher taxes in the U.S. out of fear of embarrassing the Reagan Administration. International discussions therefore have a sense of unreality right from the start. But the problem really goes deeper than this.

The finance ministers of the G-7 go off to their frequent meetings (as at the Plaza or the Louvre) without serious background analysis of the medium-term prospects for their economies or of the mutual consistency of the projected policies in the various countries. When Secretary Baker demands more Japanese expansion, for example, he does so without providing any quantitative evidence whatsoever on how much such an expansion would affect the U.S. or Japanese economy. The U.S. demand is wholly a political one, not solidly justified. Most economists have found in their analyses, for example, that even a quite significant fiscal expansion in Japan would have only a modest effect on the U.S. economy, far less than could justify the bullying by the Reagan Administration during the past year. And yet, the official debate is never brought down into the hard realities of the numbers.

For this reason, it is imperative that the leading countries establish a more formal basis for presenting projections and policy simulations as a fundamental technical input into their proceedings. Each country should be required to make an independent set of medium-term forecasts (1-year, 3-year, and 5-year) based on alternative projections for policies in their own country and in the other economies. The U.S. should be held to account, for example, for its insistence on a fiscal expansion in Japan. What would be the quantitative effects of a 1 percent fiscal expansion on Japanese GNP, U.S. GNP, and the trade balances of the two countries? The scenarios arrived at by

the various countries could then be compared and criticized, as the basis for negotiations over proposed policy changes.

These policy exercises should be carried out on a quarterly or half-year basis by the participating countries. The technical staff of the IMF could also submit studies, but the IMF analysis should not be used as a substitute for such work within each of the G-7 countries. That is because the political and educational value of formulating a multicountry forecast within each country would be lost if the work were simply taken over by an outside technical agency, whose conclusions could then easily be doubted or ignored.

Without such thorough preparation, the leading countries will continue to be ineffectual in mapping out reasonably consistent sets of policies, and will be hamstrung in discussing the major structural changes that will be required in the various economies over the next few years. Policy coordination will continue on an ad hoc basis, with finance ministers chasing furiously to hotel suites for dramatic weekend meetings, rather than confidently meeting on a regular basis with a converging viewpoint on the functioning of the world economy.

Senator SARBANES. Thank you.
Mr. Bryant, please proceed.

STATEMENT OF RALPH C. BRYANT, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. BRYANT. Mr. Chairman, we really do have an embarrassing degree of consensus here on the basic points you have asked us to discuss.

If you read my prepared statement, which is in the form of an article, written with a colleague of mine, that's just appeared in the Brookings Review, you will, of course, find remarks that are even more cogent and scintillating than the ones that you've heard already. But I think as a service to you, I should try to omit a good part of the places where my comments would duplicate what has already been said and I'm also going to resist the temptation to take up points of disagreement because I think they are much less important than the basic points where we do agree.

What I had planned to do in my oral remarks was to make some observations about the U.S. external deficit, also known as the current account deficit; its largest component, the trade deficit; the reasons, why those deficits grew to be so large in the last 6 years; the reasons why they have so far stayed large; and the prospects for a decline in those deficits. That was going to lead me to a discussion of the main part of my remarks about the risks of recession in the world economy and what kind of a package of cooperative measures one ought to want to see at the Venice summit or in other forums where the United States discusses with other governments the policies that we ought to take.

On the last part of my remarks, I really do stongly agree with both Stephen and Jeff, so I think it might be most useful if I try to elaborate just a little bit on the reasons why we have had the big external deficit and what the prospects are for its reduction. I will dot a couple of i's, I hope, on the question of what package we might support for cooperation among governments, and then leave the rest for questions and for you to read in the article.

Just one very important point which I think is getting lost sight of here in Washington, especially on Capitol Hill, about our external deficit. I think the overwhelmingly important causes of the big deficit are two macroeconomic factors—relative differences in the growth of domestic demand in the United States and abroad, and the tremendous appreciation of the dollar that occurred between the summer of 1980 and early 1985.

Recently, we had a workshop meeting at the Brookings Institution that brought together many of the principal people who have econometric models of trade-price equations and trade-volume equations. We asked them to perform historical tracking experiments with those equations, and we discovered there's a great degree of consensus that these macroeconomic factors are the reasons we have the big deficits.

We don't have to appeal to unfair trading practices abroad or structural changes in the U.S. economy or foreign economies to explain why we have had the big ballooning of our external deficit and why Japan and Germany's surpluses have become so large.

It is not credible to say that increasing protectionism abroad is a major part of the reason for the external imbalances in the world today, and it's also quite implausible to me to believe that some kind of protectionist action here at home can have a major effect on our deficit.

It's often said that adjustment in our external deficit is taking longer than expected. I don't believe that myself. I think that's a misconceived notion of why the deficit has remained so large and there is a discussion in my article about that which I won't repeat here. There are very long lags in this process and we have already seen in the last few months strong evidence that the deficit in volume terms has finally turned. That's also true taking the most recent trade statistics into account. I think most of the newspaper commentary on the February trade statistics have the story wrong. They didn't give enough emphasis to the fact that the January deficit was revised down and if you take an average of January and February together and compare it with the fourth quarter of 1986, the deficit is lower. And if you look at the GNP accounts and look in volume terms, there is a clear turn.

At this workshop I mentioned, we did ask these people to look ahead and project what might happen to the U.S. deficit given some common assumptions. The assumptions we gave them initially were reasonably steady growth at about 3 percent per year here in the United States and the same in Europe and Japan. We asked them to hypothetically hold exchange rates unchanged about where they were in the third quarter of 1986. They, then projected the deficit forward and they also ran some experiments for which we adjusted the exchange rate assumption.

So, for example, because the dollar has depreciated significantly more since the third quarter of 1986, we can adjust these projections for this additional depreciation.

When you look at these projections, you observe a lot of diversity. There's nothing like unanimity among these models in looking at the future. But there are two central points that I think emerge and they are robust across almost all of these models. So again, I think it's an example of the thing that Jeff was referring to. There's much more consensus among the profession than there usually is about these matters.

The first point is that there's unambiguously strong improvement in the trade picture in the works this year and next year. That's especially true in volume terms, but it will even be true in nominal terms. That is, the trade balance as we usually see it in the newspapers and the current account balance will improve, though I think most of that improvement is likely to occur in 1988 rather than 1987.

But for the longer term, if we look beyond 1988, the outlook isn't so rosy. Most of these analytical efforts to look at this problem show the improvement stopping sometime in 1988 or 1989, and a number of them suggest that the trade balance—certainly the current account balance—might begin to worsen further.

So there's good news in the short run ahead, point one. Point two, we ain't out of the woods yet by a long shot in adjusting these external imbalances.

Now I want to just reinforce one point that both Stephen and Jeff have made and that's asserted strongly in our article, too. The turn in our external deficit in the United States is going to cushion economic activity here this year and next, but by the same token, it's going to have a contractionary effect abroad. In Europe and Japan, domestic demand has already been growing much too slowly and this additional contactionary impetus has to be offset with some measures to increase domestic demand there unless we want to see at the least a growth recession and perhaps a bad recession in Europe and Japan.

You already referred in your opening remarks, Mr. Chairman, to the fact that the outlook looks pretty soggy, either the IMF or the OECD thinks it looks quite soggy, in Germany and Japan and most of the other industrialized countries. That's a very worrisome thing and even more so when we consider the developing countries and the debt problem and the things that could come out of the woodwork if the developing countries can't keep up their exports to Europe and Japan at the same time that our market is getting to be tougher for them because of the improvements in our competitiveness.

For my taste, Jeff Sachs has overstated the point that fiscal and monetary expansions, especially fiscal expansions, abroad couldn't do very much for either our trade balance or the adjustment of the problem. Many of these models which people have tried to use to analyze this do not include the developing countries; they can't yet take account of all the interactions in the world economy.

I think if we were to look at the indirect effects of, say, expansionary action being taken in Europe and Japan, we would find that the ultimate effects on the United States are more beneficial than many of these models say.

One or two points about the package of cooperative measures that I and the other witnesses would like to see. I believe that both fiscal and monetary policies abroad should be used. I'll take Stephen's emphasis on fiscal and Jeff's on monetary. It's about 59th on my list of worries that we would have excessive expansionary action abroad in the next year or two. I see the risks much the other way.

In the medium longer run, however, it is definitely true that Germany and Japan and many other foreign governments are quite concerned that world demand might be excessive because of U.S. policies, and I strongly agree with what's been said here about the U.S. budget deficit.

What the world needs, looking ahead over the next several years, is a shift of domestic demand away from the United States and into the major foreign industrial countries which, in turn, would support growth in the developing countries. The Germans and Japanese are quite concerned that if they boost demand and there's no credible prospect of a reduction in our budget deficit, that in time total world demand could be excessive. That seems to me a reasonable concern on their part and it makes it all the more important that the President and our administration and the Congress be able to give some credibility about the mix of our budgetary and monetary policies.

On that score, we don't have any credibility abroad. Enormous amounts of lipservice are paid, especially in the White House but in this building as well, to the need to reduce the budget deficit. But I think foreign governments know that it's largely been lipservice up until the last year, and the definite progress that's been made in the last year isn't nearly enough.

The international agreement that I believe is desirable and Mr. Marris and Mr. Sachs have described is economic common sense, but we all know that common sense isn't so common. One of the difficulties with it is it's a house of cards politically. If one government won't play—for example, if the United States could not come forward with a credible policy for changing our mix—reducing our budget deficit with the help of a tax increase—then it's very much more unlikely that the Japanese and the Germans would take the combination of expansionary actions that they should take.

So, as the others, I'm not so sanguine that an agreement can be reached, but it seems to me it's a great pity. It's badly needed. I will conclude with a story I've mentioned before on the Hill which seems to me as pertinent as ever. It's a story about the captain of a sailing ship and he's asked, "What do you do if you find yourself windward of a island in a typhoon?" And his answer is, "You make damned sure you don't find yourself windward of an island in a typhoon."

[The article referred to by Mr. Bryant follows:]

[From the Brookings Review, Spring 1987]

The External Deficit: Why? Where Next? What Remedy?

Ralph C. Bryant and Gerald Holtham

THE CURRENT ACCOUNT DEFICIT in the U.S. balance of payments, for most of the 1980s, was just an economic statistic confined to the business pages. Now, however, that external deficit is a central economic and political issue that generates front-page headlines.*

The new public interest is justified. Because of the deterioration in the external deficit since 1980, the United States has slipped — suddenly and dramatically — from being the world's largest creditor country to being its largest debtor. An external deficit as large as the existing one — some $150 billion in 1986 — is very difficult to remove quickly. Fears that U.S. indebtedness will continue to grow, perhaps to an alarming extent, are well-founded.

Unfortunately, increased interest in the external deficit has not led to an increase in clear thinking about it. In the United States, ill-informed commentators assert that recent depreciations of the dollar are failing to reduce the external deficit. Protectionist sentiment is intense, even though the deficit was not caused by growing protectionism abroad and will not be cured by it at home. Facile critics in other countries call on the United States to "put its house in order" — always good advice, especially applied to someone else's house — with no apparent awareness of the likely consequences if the advice were implemented. Some foreign governments seem to believe that, while a further depreciation of the U.S. dollar would be bad for them, a recession in the United States would be a matter of indifference. In either event, they are reluctant to assume public responsibility for the level of demand in their economies.

Against this background, a recent workshop at Brookings assessed the origins of the U.S. external deficit and the prospects for its decline. Participants from several countries prepared and evaluated econometric and other evidence (see box). This article, informed by those analyses, discusses the causes of the external deficit, its probable future evolution, and the best means to reduce it. The conclusions here, it should be stressed, are our own. Participants in the workshop have not reviewed this article and do not necessarily sanction its inferences.

Why the Deficit Ballooned

There is no mystery about the causes of the swelling U.S. external deficit. They are chiefly macroeconomic. Other causes commonly said to be important, such as "unfair trading practices" abroad or structural changes in the U.S. and foreign economies, simply do not explain most of what has happened.

The Brookings workshop firmly established this conclusion. A half-dozen macroeconometric models were asked to "predict" the external deficit for the period 1980–86 by running their equations for the volumes and prices of exports and imports. All of the models took as given the historical values for exchange

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rates, domestic prices, and economic activity in the United States and other countries. Every model predicted current account deficits close to their actual values. The predictions were often within a few billion dollars in 1986, five years after the start of the dynamic simulations.

To be sure, the experiment showed that the models are limited in their ability to forecast detailed patterns of trade. Mistakes were made over components of the current account balance. However, different models made their larger mistakes over different components. There were few common surprises. Furthermore, the more successful models showed no sign of errors growing over time. They were as likely to make a sizable mistake for 1980 as for 1985. That fact is strong evidence against the assertion that there has been a break in historical relationships. Such a break would lead to sustained or cumulating prediction errors.

What were the chief movements in the components of the external deficit associated with its emergence and widening since 1980? Prices were not to blame; the dollar prices of nonagricultural exports and non-oil imports showed relatively little net change over the 1980–86 period. The swelling deficit stemmed from a doubling in the quantity of non-oil imports while U.S. manufactured exports stagnated and agricultural exports fell sharply. Against that, the fall in oil prices, combined with energy conservation efforts, led to a sharp drop in the value of oil imports. These movements in the components of the trade balance combined to produce the 1980–86 deterioration of $127 billion. A further deterioration of $20 billion occurred in the non-trade components of the current account. These changes are summarized in table 1.

Among the proximate factors used by models to "explain" the external deficit, two are overwhelmingly important: strong U.S. domestic demand growth during a world recession combined with a relatively feeble recovery abroad; and the large appreciation of the dollar from 1980 through early 1985. A factor that seems to be important but that the models do not adequately capture is the debt crisis and persistent weakness of activity in developing countries, which were important markets, particularly for U.S. agricultural exports.

The existence of several factors all working in the same direction, tending to widen the deficit, means paradoxically that the deficit is "too" easy to explain. The deterioration can be accounted for in different ways by giving different weights to the various factors.

For example, one of the models suggests that if U.S. and foreign GNPs had remained at their 1980 levels, everything else being equal, about a quarter of the U.S. external deficit would not have occurred. If relative prices in the United States and abroad had remained at their 1980 levels, about three-quarters of the deficit would not have occurred. The changes in price competitiveness that occurred can be traced to the rise of the dollar between 1980 and 1985. Other factors that tended to worsen the deficit were more than offset by favorable elements such as the decline in oil prices.

Other models participating in the workshop give a somewhat different breakdown. One places much more importance on relative growth rates, leaving less than two-thirds of the deficit to be explained by competitiveness (primarily exchange rate) effects. Two give slightly more relative weight to dollar appreciation. These differences have more than historical significance. They mean that, even on the basis of common assumptions, the models predict different evolutions of the deficit from now on.

Economic analysis is less secure in analyzing the fundamental causes of the external deficit — for example, the factors that caused exchange rates and GNPs to move as they did. Growth differentials between the United States and the other members of the Organization for Economic Cooperation and Development (OECD) are substantially explicable by policy differences, particularly relative fiscal policies, which were expansionary in the United States after 1981 and equally contractionary elsewhere. On the basis of actual fiscal and monetary policies, however, the models would have predicted only one-half or less of the rise in the dollar that actually occurred. No empirical economic model can successfully explain the remaining appreciation, particularly not the surge in 1984 and the first months of 1985. That failure means in turn that the models are capable of predicting only half to two-thirds of the external deficit on the basis of policies alone.

Why the Deficit Has Stayed So Large

By February 1987 the external deficit showed little apparent improvement, even though the dollar had been depreciating for nearly two years. Why, it is frequently asked, is the adjustment taking "longer than expected"?

Is it really taking longer? Our answer, drawing on the workshop finding that the models correctly track the deficit right into the second half of 1986, is no. Expectations that the improvement would take less time are based on incomplete or faulty analysis.

The effective depreciation of the dollar relevant to its effects on the current account balance is less than the steep decline since the short-lived peak of February–March 1985. That peak was not sustained very long and was never

"Protectionist sentiment is intense, even though the deficit was not caused by growing protectionism abroad and will not be cured by it at home."

incorporated in trade prices. And while the dollar fell throughout the last three quarters of 1985, its average effective value during 1985 was still well above its average value during 1984. Period averages are more important than day-to-day quotations in assessing the influence of exchange rates on trade prices.

When the path of the dollar's exchange value is correctly incorporated into the analysis, the time taken for the external deficit to begin improving is not a surprise. Relationships based on history make it clear that a lengthy period for the turnaround is necessary. First, trade prices respond sluggishly to exchange rate movements; this lag is especially important for the dollar prices of U.S. imports. Second, the volumes of exports and imports (flows at constant prices) react slowly to changes in relative prices; distributed lags extending beyond two years are common in trade models. Third, though both react slowly, trade prices adjust faster than trade volumes, leading to a short-run worsening of the current price balances, the so-called "J-curve" effect. (In particular, import volumes initially decline less in response to dollar depreciation than import prices rise, leading in the first instance to an increase rather than a fall in the value of imports.) Even though the trade and current account balances initially fail to improve at current prices, a gradual improvement in the constant price balances does begin immediately. Given the nearly continuous depreciation of the dollar over the past two years, moreover, an entire family of J-curves has been in effect. The deficit must navigate around the whole family of curves before the full effects of the exchange rate changes become evident.

Other countries typically have waited two years or more to see the benefits of a currency depreciation. In addition, adjustment of the U.S. external deficit in response to

Table 1. The U.S. External Deficit by Major Component, 1980–86

Component or balance*	1980	1986**	Change from 1980 to 1986 $ amount	Change from 1980 to 1986 % change
Nonagricultural merchandise exports				
Current dollars	$183	$194	$ 11	6%
1982 dollars	203	208		3
Price index	90	93		3
Agricultural merchandise exports				
Current dollars	42	27	−15	−37
1982 dollars	39	30		−24
Price index	108	90		−17
Non-oil merchandise imports				
Current dollars	168	335	167	99
1982 dollars	171	344		102
Price index	99	97		− 1
Oil imports				
Current dollars	79	34	−45	−57
1982 dollars	83	76		− 8
Price index	96	47		−51
Net receipts, investment income				
Current dollars	48	37	−10	−22
1982 dollars	56	33		−41
Net receipts, other services				
Current dollars	7	7	− 0	− 6
1982 dollars	13	0		−97
Net transfer payments to foreigners				
Current dollars	7	15	8	112
Trade balance				
Current dollars	−22	−149	−127	
Balance on current account				
Current dollars	2	−145	−147	
Real net exports of goods and services				
1982 dollars	57	−150	−207	

*Figures for current dollars and constant 1982 dollars are in billions. Figures for the price indexes use a base of 1982 = 100. Dollar and percentage changes are calculated from unrounded figures.

**Preliminary figures. Data for net transfer payments and current account balance partially estimated by authors.

Source: Bureau of Economic Analysis. *Survey of Current Business.*

currency depreciation is probably slower than it would be for other countries. The U.S. domestic market is the world's largest and most important. It is likely that foreign exporters take account of U.S. domestic prices and set their own prices competitively, rather than applying a fixed markup on their costs. In other words, foreign suppliers accept more variable profit margins in their effort to keep a position in the U.S. market than they do elsewhere and more than U.S. suppliers accept when exporting. Such pricing behavior is not a surprise; several models predict it. Nor does it negate the effects of exchange rate changes on trade, but it does slow down speeds of adjustment. Eventually, import prices come to reflect foreign costs, or the supply of foreign goods falls back, reflecting the lower profit margins in the U.S. market and a consequent reduced investment in marketing imports. This latter effect, however, can take years to reveal itself fully.

Will the Deficit Ever Decline?

If there is little or no mystery about the recent history, what lies ahead for the U.S. external deficit? Consider first the prospects for the next two years.

The models participating in the Brookings workshop were asked to project the external deficit and its components, at both constant and current prices, using the assumptions that the U.S. and foreign economies each grew at similar rates and that the exchange value of the dollar remained unchanged in real terms from the average value prevailing in the third quarter of 1986.

Between the third quarter of 1986 and late January 1987, the dollar declined by another 6 to 9 percent (the amount varying with the type of index used). The likely effects of that additional depreciation can be roughly calculated from other workshop materials. Figure 1 shows the actual history of constant price net exports of goods and services through 1986 and projections of the various models for 1987–91 adjusted for an additional 10 percent dollar depreciation. Figure 1 also shows a "combined-model" projection, calculated using weights based on the relative performance of the models in predicting the 1980–86 history.

Given the specified assumptions, the models agree that there should be sizable improvement in the constant price deficit during 1987–88. Projected net exports of goods and services at constant 1982 prices improve by as much as $30 billion to $35 billion in 1987 and by almost as much in 1988.

For the external deficit at current prices, calculations of a combined-model projection show an improvement of some $25 billion to $30 billion in the next two years, although it comes entirely in 1988.

It is the deficit in current prices that gets the lion's share of public attention. And the current price balance does show what the United States must borrow abroad to finance the deficit. Yet it is the deficit in constant prices that is relevant for assessing influences on real GNP and jobs, both in the U.S. economy and abroad. For 1987–88, moreover, the reduction in the constant price deficit is significantly larger than the improvement measured in current prices.

Unfortunately, prospects for improvement are not so rosy as one looks beyond the next two years. The models differ considerably in their projections of the external deficit for 1989–91 (see figure 1). The greatest variation stems from different estimates of the consequences of dollar depreciation. Still, there is a consensus that the depreciation that occurred through late January will not be sufficient to eradicate the deficit at either current or constant prices. If there is no further dollar depreciation, and if the U.S. and rest-of-world economies were to grow at roughly similar rates, the lagged effects of the currency changes occurring through January 1987 would have largely worked themselves out by 1989. Indeed, weighted averages of model projections show the trade and current account balances deteriorating again after 1989. As a percentage of GNP, the current account deficit never reaches its 1986 level of about 3⅓ percent, but after falling to a low around 2 percent in 1989, it rises slightly thereafter.

With the external deficit still fairly large even after 1989, the net external debt position of the United States would still grow rapidly. Correspondingly, debt service payments to foreigners would continue to increase, adding larger and larger negative numbers to the current account.

Virtually all analysts expect a continuing deterioration in the net external asset position, and hence the growing burdens of debt servicing. The prediction that the current balance will start to worsen again after 1989, therefore, is likely to be robust. Because of technical differences in model specifications, however, we would not be inclined to

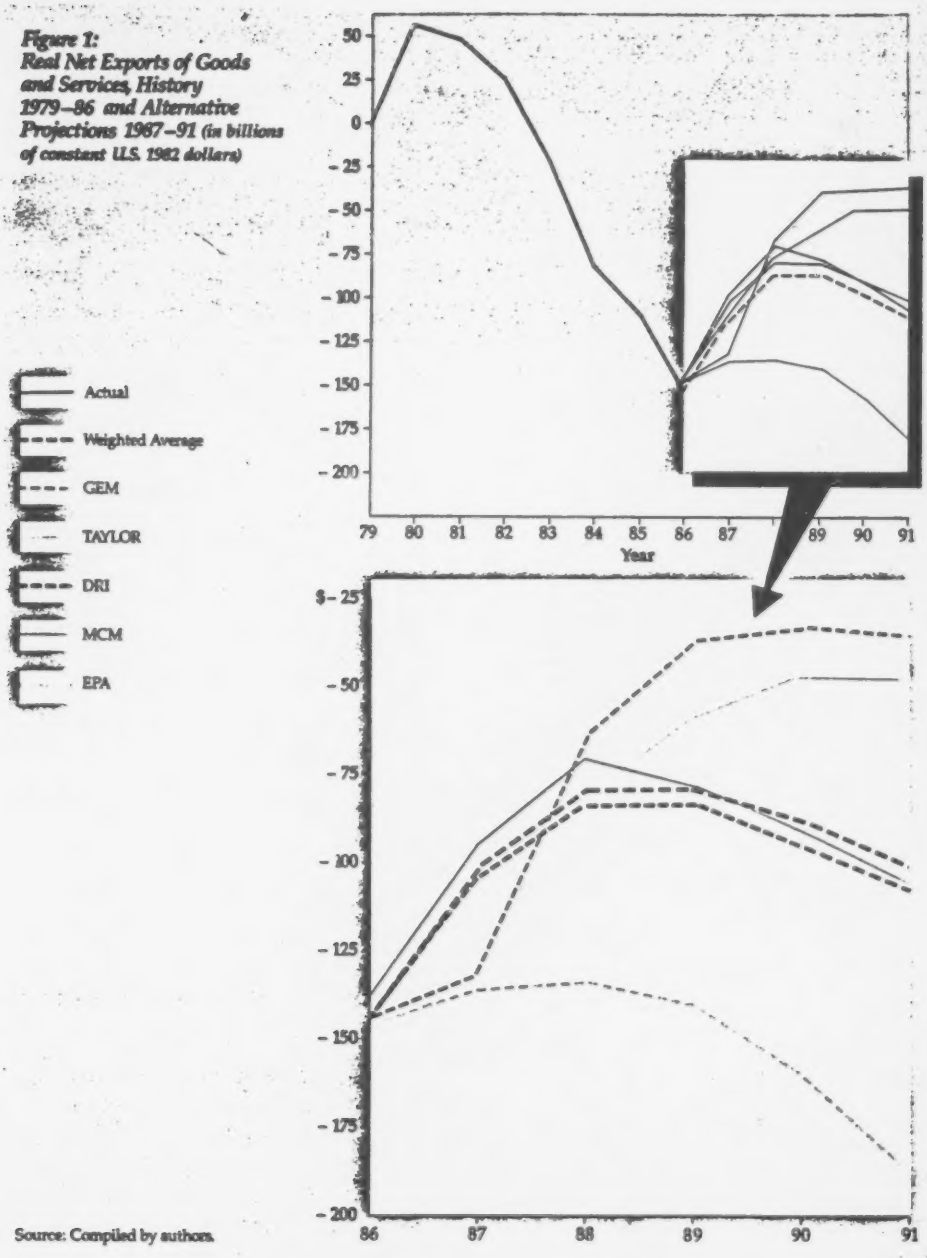
The Brookings Workshop

The workshop on the U.S. current account imbalance, held at Brookings on January 20, 1987, compared alternative empirical approaches to analysis of the U.S. external deficit, seeking to improve understanding of the reasons for the deficit and to shed light on policy options for correcting it. The workshop is part of a research program entitled Macroeconomic Interactions and Policy Design in Interdependent Economies, jointly sponsored by Brookings and the Centre for Economic Policy Research in London and financed by a grant from the Ford Foundation.

The participants, acting as individuals, not representatives of their institutions, included analysts who are responsible for the construction and operation of the following econometric models: Data Resources International Model (DRI), Japanese Economic Planning Agency World Model (EPA), Federal Reserve Board staff Multicountry Model (MCM), the Global Economic Model of the National Institute for Economic and Social Research in London (GEM), the OECD Interlink Model (OECD), John Taylor's Multicountry Model (TAYLOR), and Wharton Econometrics International Model (WHARTON). All model groups, using uniform assumptions, reported the results of historical-tracking experiments; some groups carried out forward-looking simulations. In addition, papers were presented by William Helkie and Peter Hooper on "The U.S. External Deficit in the 1980s: An Empirical Analysis" and by Paul Krugman on "Has the Dollar Fallen Enough?"

Single copies of the model groups' reports, comparative materials based on those reports, and the papers, including a more detailed version of this article, are available in the form of Brookings Discussion Papers in International Economics.

Figure 1:
Real Net Exports of Goods and Services, History 1979–86 and Alternative Projections 1987–91 (in billions of constant U.S. 1982 dollars)



Source: Compiled by authors.

put too much weight on projections of a deterioration in the trade balance after 1989. At any rate, it is a matter of concern for policy that the trade deficit could get stuck above $100 billion, while the current account deficit deteriorated in relation to GNP.

A mechanical application of model results might appear to suggest that a further depreciation of the dollar against all other currencies — not simply the yen and the currencies of the European Monetary System — of 20 to 30 percent would be necessary and sufficient to achieve eventual elimination of the U.S. external deficit. Such an inference, however, would not be justified. The model calculations underlying such an inference are partial, the result of changing one variable, such as the dollar's exchange value, while all others are held fixed. In practice such a large additional depreciation would not leave all other variables unchanged. On the contrary, it would have a strong inflationary impact in the United States and a deflationary impact abroad. Both of those effects would tend to feed back on the external balance, limiting its improvement. Indeed, if the United States were able to achieve a swing in its real net exports of goods and services of even $100 billion, the domestic economy would probably overheat in the absence of other policy measures.

Moreover, the exchange value of the dollar is not a policy instrument that can be manipulated at will by governments. When assessing the probable effects of a large dollar depreciation, it is thus necessary to ask what induced the depreciation. The effects of a further 30 percent drop in the dollar would be quite different if the decline were brought about by a shift in market expectations than if it were a result of deliberate monetary policy.

All in all, a safer inference is that while the decline in the dollar from early 1985 to early 1987 will make a substantial contribution to reducing the external deficit, and while some further depreciation is probably in order, it is highly unlikely that the deficit problem can be solved by dollar depreciation alone. The conclusion is inescapable that other public policy action is required.

Risks of Recession in the World Economy

That conclusion is strengthened when the prospects for demand and output in the world economy are taken into account. During the years when the U.S. external deficit was worsening, U.S. real GNP grew on average at an annual rate of less than 2½ percent, while total domestic demand at constant prices grew at over 3½ percent. The growing excess of imports over exports was a significant drag on the expansion of the economy. In 1986 the deterioration in the external balance at constant prices cost about one percentage point of growth.

If the external balance at constant prices simply fails to deteriorate in 1987, and if domestic demand holds up, growth would be 1 percent faster than in 1986. The model projections summarized earlier, moreover, imply a further boost to the 1987 growth rate of nearly one percentage point. The total swing in the external balance could therefore add up to two percentage points to the 1987 growth rate relative to the 1986 rate. Of course, that figure also depends on particular assumptions about foreign demand growth, which might well not be realized.

For the world economy as a whole, faster U.S. growth due

". . . while the decline in the dollar from early 1985 to early 1987 will make a substantial contribution to reducing the external deficit, and while some further depreciation is probably in order, it is highly unlikely that the deficit problem can be solved by dollar depreciation alone. The conclusion is inescapable that other public policy action is required."

"A growth recession abroad is not sure to happen. It is not even the most probable outcome. It is nonetheless a distinct possibility and is certainly the gravest risk now facing the world economy, threatening much more than the orderly shrinkage of the U.S. external deficit."

to a swing in the external balance is at someone else's expense: in effect, coins are taken out of the left pocket and put into the right. Thus in sharp contrast to 1983–86, when the growing U.S. current account deficit supported growth in the rest of the world, correction of the deficit must now subject foreign economies to a strongly contractionary influence.

Prospects for real growth in Europe and Japan during 1987–88 are already soggy. Last December the OECD Secretariat, for example, forecast real growth in 1987 for OECD countries other than the United States of only 2¼ percent. Economic indicators released subsequently suggest that domestic demand is growing more slowly than expected, particularly in Germany. The dollar has already depreciated by an additional 4 to 7 percent since the OECD and other year-end forecasts were made, further weakening net export prospects abroad. It is not clear, moreover, that many forecasts allowed for as large a constant price swing in the U.S. deficit as we believe could occur.

These considerations raise a disturbing possibility. The rest of the OECD is much too close to the prospect of a real growth rate below 2 percent — a growth recession by any reasonable definition.

The direct impact on the U.S. external deficit of slower foreign growth is substantial. Model calculations suggest that 1 percent slower foreign growth could enlarge the deficit by as much as $20 billion to $30 billion over four years. Indirect effects must be considered too. Slower foreign growth could reduce interest rates and depress stock markets abroad and so tend to prop up the dollar. A growth recession starting in other OECD economies could have highly adverse effects on developing countries, many of which are already strained by heavy debt servicing obligations. By eroding the ability of those countries to keep up their exports when the U.S. market was already getting tougher, a slowdown in Europe and Japan could exacerbate the debt crisis and threaten the liquidity of the world's private financial institutions. Even without financial instability, yet more sluggish growth outside the United States could damage confidence, causing investment to sag below its current mediocre rate. And if activity in the rest of the world fell off substantially, the improvement in the U.S. current balance projected earlier would be greatly reduced.

A growth recession abroad is not sure to happen. It is not even the most probable outcome. It is nonetheless a distinct possibility and is certainly the gravest risk now facing the world economy, threatening much more than the orderly shrinkage of the U.S. external deficit.

For completeness, we should also note the argument that a sudden steep decline in the dollar is the largest threat to world economic recovery. Subscribers to this view contend that if exchange markets become persuaded that a very large further drop in the dollar is needed for external balance, foreign holders of U.S. securities could decide that yields were insufficient to compensate them for further falls in the dollar. Because the United States will need to borrow over $100 billion a year from foreigners for the foreseeable future, an incipient drying-up of the flow of foreign funds could push up interest rates and precipitate a slowdown in the United States.

We believe that the risks of this scenario occurring are modest. But there is little need to debate which of the various unpleasant possibilities is the one to fear most. They all point to similar policy prescriptions: cooperative measures aimed at facilitating correction of imbalances while maintaining growth, particularly growth abroad.

International Policy Cooperation

A correction of the U.S. external deficit — however it is achieved — will have deflationary effects on economic activity outside the United States. It is essential, therefore, that the governments of other industrial countries acknowledge their responsibility and capacity for maintaining the growth of domestic demand in the face of that deflationary impulse. Ideally, foreign governments would go further and seek to attain somewhat higher growth rates for their real GNPs than the below-potential rates that characterized the 1982–86 period. Individual foreign countries are reluctant to initiate expansionary action on their own. They fear such actions, taken in isolation, would generate risks that outweigh any expected benefits.

Differing views exist about the balance of risks. Foreign governments are very concerned about the U.S. budgetary situation and what it portends for inflation and currency instability in future years. The bloated federal budget deficit, the largest part of which is now structural, not cyclical, would almost certainly entail excess demand in the United States if it persisted while the external deficit was greatly reduced or eliminated. The United States needs to acknowledge that point and accept that actions by foreign governments to maintain demand abroad depend on credible further cuts in the U.S. budget deficit. No less important, foreign governments should acknowledge that rapid cuts in the U.S. budget deficit in the absence of actions to maintain demand abroad could entail world recession.

The outlines of a mutually beneficial agreement among the major industrial countries can be readily identified. Such an agreement would have five main features. First, all participating governments would commit themselves to the goal of reducing the large current account imbalances presently troubling the world economy. That means, in particular, large reductions in the U.S. deficit and counterpart reductions by those OECD countries whose surpluses are inappropriately large in relation to the size of their economies.

Second, foreign governments would agree to take timely policy actions to maintain the growth of output as external imbalances are adjusted. Third, the United States would commit itself to a change in the mix of its policies, ensuring a reduction in the size of future structural budget deficits. Fourth, the United States and other governments would announce their expectations — a "cooperative presumption" — about a lower exchange value of the dollar that they regarded as consistent with the preceding goals and policies. This presumption would be stated in the form of a broad range, not a single number. Fifth, governments would once again renounce protectionism and renew their commitment to examine trade policy problems cooperatively.

While there is something in this package that each participating government would find difficult, there are also features each should want. Many foreign governments, for example, believe that the dollar is already undervalued; they would like to discourage a further dollar depreciation. Yet the results summarized above strongly suggest that a reduction of the U.S. external deficit in combination with sustainable growth targets will require some further depreciation. This requirement cannot be avoided by cutting the U.S. budget deficit. Indeed, a reduction in the budget deficit would by itself reduce activity in the United States and thereby lower interest rates, which normally would lead to a dollar depreciation. The desired tightening of fiscal policy in the United States would therefore tend to strengthen foreign currencies, unless accompanied by a U.S. monetary contraction. Combined fiscal and monetary contraction in the United States would, however, precipitate a U.S. recession, which, on current policies, foreign economies could not withstand.

A cooperative presumption about a moderate further decline in the dollar (with understandings, perhaps only qualitative, about the currencies against which it was most likely to occur) is therefore an important part of any viable agreement. The participating governments need not make — and could not credibly do so — an absolute commitment to maintain dollar exchange rates within the ranges given by their agreement. Rather, the announced ranges would be their own rough estimate of where the fundamentals should be moving the exchange value of the dollar over the period 1987–90, taking into account the implications of their own joint policy actions.

The path of the dollar's exchange value depends critically on the other parts of the agreement. If governments agree, for example, on how much current account imbalances should be reduced, then the slower the rates of demand growth to which the Japanese and European governments can commit, the larger must be the additional appreciation of the currencies of surplus countries. If the United States restrained domestic demand growth by fiscal restriction on or near the Gramm-Rudman path, while the surplus economies targeted nominal GNP growth of not less than 5 or 6 percent, the presumptive additional dollar depreciation might be set in a range of 10 to 25 percent.

A contingent presumption of this sort about further dollar depreciation, it should be emphasized, does not imply "target zones" for exchange rates. Moreover, in the absence of agreement about rates of demand growth and the other parts of the package, it would *not* be desirable to announce such a presumption (much less imply that actions would be taken to keep exchange rates in conformity with such a presumption).

Foreign governments could take several combinations

The Paris Agreements

As this article went to press, the finance ministers of Canada, France, Japan, the United Kingdom, the United States and West Germany met in Paris February 21–22 to discuss the international economic situation. Our analysis, particularly our suggestions for greater international cooperation, have not been superceded by the decisions announced there.

Although a welcome initiative, the meeting in substance fell well short of its rhetoric on cooperation. The promised new German tax reductions are modest and will not be implemented until 1988. Japan will adopt the promised stimulative policies, if at all, only after the Diet approves the pending 1987 budget proposal, which is itself restrictive, not expansionary.

The Paris announcement that governments will "foster stability of exchange rates around current levels" could be, like the U.S.-Japanese statement of October 1986, little more than an official hope that the exchange markets will avoid further downward pressure on the dollar for the time being. If the words turn out to be underpinned by commitments to prevent further dollar depreciation, the understanding is likely to prove fragile. Reduction of the large external imbalances among the major countries cannot be attained without, eventually, further dollar depreciation. If participating governments try to stabilize exchange rates around the levels of February 1987, moreover, they may be forced to adjust their monetary policies to that external goal rather than to their output and inflation objectives — a reversal of priorities that would not, and should not, command domestic political support.

of policy actions that would support the agreed targets. Some foreign fiscal expansion through tax cuts would be helpful. Fiscal expansion would raise demand and imports in foreign economies without necessarily leading to depreciation of foreign currencies, as foreign monetary expansion would. Many foreign governments, however, are reluctant to undertake fiscal expansion because of concern with the medium-term outlook for their public sector budget deficits.

A synchronized easing of fiscal policy abroad, if it increased real output, would not have much adverse effect on actual budget positions. Yet governments, accustomed to weighing the effect of policy changes made in isolation, are reluctant to accept that point. Many Europeans, moreover, remain pessimistic about the ability of their economies to respond to a demand stimulus with real output. The pessimism is illogical: governments do not lose sleep over the inflationary implications of export demand, so there is no reason, with export demand weakening, why they should worry about the inflationary implications of domestic demand. Nonetheless, governments' concerns about their debt positions suggest that at least part of the foreign expansion will have to come about through monetary policy.

The relative stance of monetary policies in the United States and abroad is important. The greater foreign monetary expansion is relative to foreign fiscal expansion, the easier U.S. monetary policy must be in order not to impede the necessary additional depreciation of the dollar. Monetary policies and their relative stance would have to be adjusted, depending on what exchange markets were doing and how fast the swing was occurring in current account imbalances. Declared targets for monetary policy should be conditional, with their dependency on outcomes made clear to guide public expectations.

An environment in which foreign growth was being maintained and in which the U.S. external deficit was coming down would be the best one possible in which to undertake the necessary correction of the U.S. structural budget deficit. Indeed, a credible U.S. plan of action to reduce the budget deficit is almost certainly a sine qua non for any international agreement. The governments of Germany and Japan, in particular, would not take part in any jointly agreed actions whose global consequences they considered inflationary. Bolstering demand in the rest of the world with domestic demand strong in the United States could risk inflation not too many years ahead. A shift in the balance of domestic demands between the United States and other countries is much more likely to command acceptance than a simple boost to total world demand.

"Fiscal correction in the United States will be impossible to attain without a political compromise."

Unfortunately, the government of the United States has no credibility whatever on this subject. Administration officials have responded to overseas criticism of the budget deficit since at least 1982 by agreeing with the complaints and blaming Congress. Foreign governments have not somehow failed to notice that general lip service is paid in the United States — by the White House even more than Congress — to reducing the budget deficit, while the political deadlock that perpetuates it drags on. All parts of the U.S. government care about the budget deficit a little bit but not enough to exercise courageous political leadership.

Fiscal correction in the United States will be impossible to attain without a political compromise. And some form of tax increase will be essential. Not only is that true, but foreign governments know it is true. The recent tax reform legislation and the president's preoccupation with the negative incentive effects of high income tax rates suggest that additional revenues will probably have to come from indirect taxes. The traditional approach of raising taxes on items for which demand is relatively unresponsive to price changes — for example, tobacco and liquor — has much to recommend it. Concern with energy conservation and long-run oil consumption might argue, for example, for an additional tax on gasoline (to be channeled into general revenues, not spent on more highways).

The key point is that foreign governments would find Treasury Secretary James A. Baker III more persuasive if he had a carrot to offer as well as a stick. A credible plan for a tax hike in his back pocket would be a stronger negotiating chip than thinly veiled threats to let the dollar slide. Furthermore, the tax rise would be easier to sell to domestic political constituencies in the United States if it were part of an international agreement in which other governments were committed to doing their share.

An international agreement along these lines is economic common sense, but a house of cards politically. No part stands on its own; the package can only be drawn up and implemented if each major country agrees to make its contribution. If a player holds out or withdraws one of his cards, the whole edifice would come fluttering down.

The imagination and will required for international agreements, and the sheer hard work of crafting the details, tend to be mustered only in times of crisis. Although the dangers currently facing the world economy are real, statesmen and bureaucrats are not yet frightened enough to take constructive action. If the situation begins to deteriorate, we must all hope that their capacity for fright and foresight measures up to the imperious needs of the times.

• The imbalance in the current account of the balance of payments — what we call the external deficit — includes the transactions in goods, services, investment income, and transfer payments between U.S. residents and foreigners. The largest part of the current account deficit is the trade deficit (the shortfall of merchandise exports below merchandise imports).

Senator SARBANES. Well, gentlemen, thank you. I have just a couple of questions and then I'll defer to my colleagues.

I wanted to ask a more basic question. Are these G–7 economic summits worthwhile? They only began in 1975; before that, in the postwar period, we had to face the problem of coordinating economic policies, developing a worldwide economic strategy and so forth and so on, but my impression is that we tended to do it much more through the OECD, and in a much more professional and planned way.

We're not about to do away with the summits right now and that is not really what you were asked to look at, but I would be curious about your reactions and whether you think that these economic summits of the seven major industrialized countries are in themselves a good idea.

Mr. MARRIS. Well, I think there's one thing that's right about the summits and several things that are wrong.

The thing that's right is that they take place at the heads of state level. I was closely involved with international economic cooperation through the 1960's and the fact was that the problems got so difficult, and also so political, that it became obvious that they couldn't be resolved except at the heads of state level.

The two things that I think are very seriously wrong are, first of all, that the summit and the Group of Five were set up and operate outside the existing institutional framework. This means, for example, that the IMF is not present at the meetings of the Group of Five as of right, but only on sufferance, and only at some of the meetings. It is, therefore, naturally inhibited in putting forward severe criticisms of the members of the summit. Also, as Jeffrey has remarked, the IMF is not in the position to insist that the discussion should be organized around a competent professional piece of quantitative analysis, which I entirely agree with him has been part of the problem.

But a more obvious weakness of the summit is simply that it's unrepresentative. I mean, it is quite ridiculous for seven countries which actually include Italy and Canada to be meeting together with no country from the developing world, no representation from the developing world. And I believe that one of the reasons why the summit and the Group of Five is in the process of failing to deal with this massive disequilibrium in the world economy is simply that because of its unrepresentative nature the focus of the discussion has been wrong.

The one common political force that has driven the summit has been fear of protectionism on both sides. Thus, the focus has been almost exclusively on the dollar and on the U.S. trade deficit.

In my view, that is a much too narrow focus. We live in a market-oriented system. It was obvious from the start that in the end the markets would push the dollar down and would start reducing the U.S. trade deficit. The key question wasn't whether or how that would happen. The key question was whether it would be possible to maintain an adequate rate of growth in the world economy as a whole while that adjustment was coming about. And that,

unfortunately, wasn't what they were talking about and they're still not really talking about it. I hope they will begin to.

I would indeed support what Ralph said when Jeff was arguing that faster growth in other countries wouldn't do much to help the U.S. trade deficit. The trade deficit isn't the only problem we have out there. The problem we have out there is the possibility of a world recession.

Let me give you just one example of how the unrepresentative nature of the summit leads to it missing the point. Japan and Europe import five times more nonoil commodities than the United States. They are in fact large net importers of commodities, while the United States is a net exporter. Now that means that faster growth in Europe and Japan would have a quite disproportionate effect in boosting commodity prices, and that's what we need right now. Commodity prices are down nearly 30 percent in real terms over the last 3 years and that's what's strapping the developing countries.

This is precisely the kind of global interreaction which was brought up when I was chief economist at the OECD to think it was our job to point out to the governments. In my view it is not getting the attention it deserves because we have a self-elected, little oligopoly of countries who are basically concerned with their own bilateral economic and political frictions—who are mainly concerned with damaged limitation to avoid a crisis before their next election—and it's this that is giving them a narrow view and leading us into the sort of mess we're getting into now.

Senator SARBANES. Did anyone else want to add briefly to that?

Mr. BRYANT. I would put a slightly different emphasis on my answer. The best might be the enemy of the good here. If you had a truly representative international forum in which all countries were represented in some way, it might be too cumbersome to accomplish anything. It's a source of regret to me, as it is to Stephen Marris, that when the five or the seven get together they are a little bit too inward looking about their own problems and don't think about the rest of the world economy enough. But I suspect that it's a political fact of life that some of the important consultations between the major governments will have to be in a small group.

The point I would stress more is the need for better support for the process. When these discussions were held in the OECD, there was more professional analytical support for them and one of the things that seems to distinguish the way the summits are prepared is that there is less of that than there ought to be and less drawing on the existing international institutions, such as the IMF or the OECD where some of the competence for this resides.

The lack of attention paid by national governments to improving the analytical framework for thinking about macroeconomic interactions and the effects of one country's policies on another is really appalling. Jeff Sachs is right about that. These things matter so much. We don't understand nearly enough about them. And yet few of the national governments are willing to put the resources into the support that would enable us to do better in the future.

Mr. SACHS. Just one short comment. One proposal has been to let the IMF in and play a larger role, and I think that would not address exactly what I have in mind.

The problem is right now there is no shortage of technical analysis around the world if someone wants to find it, whether in the OECD or the IMF or in academia or wherever. The problem is getting governments when they start confronting other governments to think about that analysis. And for that reason, I think what's really crucial is that each government, and ours in particular, start doing some serious work in-house. If it's done by the IMF, it can be ignored, which is exactly what has been happening for years and the IMF is ignored and can be cowed to not draw things as starkly as they might be.

We really are missing—not just at the summit level but at the G–5 and G–7 meetings, there's a shocking lack of quantification. It's just astounding to an economist actually to observe this process. Numbers are hardly discussed in terms of what the effects of policy "a" might be on objective "b" and that has to be done within the governments as a matter of practice to get the thing going in a serious way, not just by a technical institution outside.

Senator SARBANES. Well, my 5 minutes are up. Let me just put a very quick question and get a short answer.

It is reasonable for the United States, as it deals with other countries as to the economic responsibilities they should be willing to shoulder, to consider the fact that the United States is carrying by far the largest burden on the security front? In other words, for instance, Japan puts 1 percent of GNP into defense. Some people want to press Japan to rearm. I don't know that that's the way to proceed. But why isn't it reasonable to observe that we're putting in 6.5 percent of GNP, while you're putting in 1 percent. Obviously, if we only put 1, there would be lots of things we could do that we are unable to do. And in meeting worldwide economic responsibilities, other nations must, therefore, be prepared to shoulder a larger burden. You can't look at it only in the economic terms without factoring in the security dimension.

Is that a reasonable position for the United States to take?

Mr. MARRIS. Sure. If heads of state meet, they should indeed cover the whole range of economic and other interests. The proposal that the Japanese should take over part of the responsibility for trying to see that there is adequate financing for the developing countries is an interesting answer to this question. I don't know whether anybody wants to see the Japanese spend a great deal more on military expenditure. On the other hand, they need to play a bigger role in the economic defense, if you like, of the West, and this would be a damned good way of doing it.

Mr. SACHS. I think that's absolutely right, and it's clear that there are important responsibilities of the Japanese that are not being observed even in their own region. I think about their aid for the Philippines which is lagging, which is not—they have refused to take a leadership role there. They have held back, in my view, with the Aquino government too long. They have given some money, but they haven't provided the kind of leadership that's desperately necessary in their own region.

When we've asked them to help in Latin America in the past they have constantly argued, "Well, we have our own part of the world to care about." But when it actually came to a major part of the world, I, for one, did not see that kind of action being taken and I think they should be called to it.

This debt proposal is exactly in the right vein, but if we just let it slide it will get eaten to bits. I think that it's incumbent upon U.S. policymakers to jump up right now and say, "Not only is this a good idea, but we're ready to start sitting down next week and working out the details and we don't want it whittled down into a small amount." This is an opening for us. If we don't grab it, it will get eaten up alive inside the Japanese bureaucracy. The Budget Bureau at the Ministry of Finance will take it to pieces and we will lose a very valuable opportunity that is of true macroeconomic consequence.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Well, the three of you would agree there ought to be a tax increase and agree apparently that West Germany and Japan ought to stimulate their economy.

I want to know, Mr. Marris, when you speak of commodity prices as being nonoil, I assume this is all commodities. The commodity price for Mexico would be oil and in Venezuela it would probably be oil. In Zambia, it might be copper and for somebody else it might be rice.

Is that true? All commodity prices? A wide range?

Mr. MARRIS. I was talking about all commodities other than oil.

Senator MELCHER. Other than oil?

Mr. MARRIS. Other than oil.

Senator MELCHER. You separate out oil for some reason. Why?

Mr. MARRIS. Simply because there has been a large drop in oil prices. That is more familiar. That has had an effect on reducing, as you say, Mexican imports and Venezuelan imports. What has received less attention is that, on average, the prices of all commodities other than oil have also fallen in real terms. Their purchasing power has fallen by 30 percent since mid-1984.

Senator MELCHER. Well, if developing countries such as Mexico and Venezuela and Nigeria are going to recover, don't they need an improvement in their commodity prices? They do.

Well, how do we arrive at plotting for higher commodity prices?

Mr. MARRIS. Well, I am myself greatly against attempting to rig the commodity markets. What the facts show is that the real value of commodities—that is to say, the terms of trade between commodity prices and the prices of manufactured products are subject to some long-run secular decline, but in the shorter run they are very sensitive to the rate of growth in the world economy. For example, the world economy was growing by over 4 percent from mid-1983 to mid-1984 and those prices started up in a typical cyclical recovery. They went up by about 15 percent in real terms.

Now there's been a mystery in the last year or so because normally when the dollar goes down we would expect the dollar price of commodities to go up, because otherwise what would happen, as it has happened, is that they have gone down a great deal in yen or in deutsche marks. This hasn't happened and the reason, in my view, is quite simple. It is that since the middle of 1984, growth in

the industrialized countries has been hovering between 2.5 and 3 percent, which is just about the bottom limit of the rate which would hold these prices at a reasonable level.

What we need, as I say, is faster growth particularly in Europe and Japan, and that would restore these prices to something more reasonable. Also, U.S. agricultural prices would benefit.

Senator MELCHER. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Solarz.

Professor Sachs, I know you have to catch a plane. If you reach the time, you can simply excuse yourself.

Mr. SACHS. OK.

Representative SOLARZ. Thank you very much, Mr. Chairman. Gentlemen, I have been under the impression that our own budget deficit was a major factor in the trade deficit inasmuch as it attracted a lot of Japanese and European money into the United States. That drove up the value of the dollar, which in turn made foreign imports that much less expensive and our exports that much less competitive.

But if that is in fact the case, how does one account for the fact that in spite of continuing high budget deficits the dollar has plunged in value so dramatically? If the high deficits were responsible for driving the value of the dollar up, how is it the value of the dollar has gone down even though the budget deficit has remained high?

Mr. SACHS. Paul Samuelson is fond of saying that God gave economists two eyes so he could look at two different things, one of which would be fiscal policy and another might be monetary policy if you're looking at the policy page.

There are many things that affect the dollar. Fiscal policy is one of them. Monetary policy works independently on the dollar. The U.S. has had an expansionary monetary policy in the past year. I would say it's a monetary policy that is underwriting the decline of the dollar to head off protectionism or to try to reestablish a more realistic degree of international competitiveness.

So what we've seen is very rapid growth of M1 and interest rates, until recently, coming down, and long rates coming down significantly in the past 2 years. And that is a substantial part of the explanation.

We can get the dollar as low as we want, even with large fiscal deficits, if we pump up the money supply significantly.

So I would guess that part of what's happened is that there's been an expectation of an easing of monetary policy in the past and in the future and an expectation of better fiscal management through Gramm-Rudman and other things as being part of the process of the dollar depreciation.

Representative SOLARZ. Mr. Sachs, I gather in your testimony you have estimated that the value to the United States of the Japanese proposal to recycle some of that surplus money into Latin America would be about 40 cents on the dollar, whereas the benefit to the United States of an internal Japanese stimulus package would be about 20 cents on the dollar.

Mr. SACHS. That's right.

Representative SOLARZ. Is that more or less accepted among your——

Mr. SACHS. No. I don't think anyone has looked at this proposal with a lot of rigor. This was running it through the crank after it was announced, but it is not accepted.

Represenative SOLARZ. I just returned from a brief trip to Korea and Japan and I was struck by the fact that amidst the raging debate over protectionism and free trade in our country where the argument is often advanced that protectionism was economically counterproductive, here you have two countries, particularly South Korea, over the course of the last two decades which have had spectacular economic growth in the context of much more protected economies than our own. And if you look just at those two examples, one might conclude that protectionism benefits an economy and facilitates economic growth.

Yet all the economists one speaks to here argue that protectionist policies are economically counterproductive.

Can you help to resolve this paradox as well? You did fairly well on the first question.

Mr. SACHS. You asked a tough question, but it's one that I actually give a lot of my professional thought to. Let me give you a nutshell answer as I see it.

Protection can be a key part of a successful development strategy and it has been, particularly in Asia. It's also worked in Brazil. That is because for an economy with a relatively small market, protecting key strategic parts of that market can allow firms to develop and then become internationally competitive. If the protection is done in the context of a general export promotion strategy, as seems to be in the case in Asia, I think one has to say that the old nostrums of economics for many, many reasons simply don't apply.

With respect to the value of such a policy generally for the United States, for instance, the United States is the world's largest integrated market and we don't really need that kind of protection to do the kinds of industrial policy to protect nascent markets before they become internationally competitive. So for strategy for us, I'm not sure that——

Representative SOLARZ. Well, does the case of South Korea and Japan demonstrate that industrial policies can work?

Mr. SACHS. Yes, absolutely.

Mr. MARRIS. Yes, as long as they're unwound soon enough.

Mr. SACHS. No—30 years——

Mr. MARRIS. Take Australia. Australia has been protectionist for so damned long and never undone it, and the result is disastrous.

Mr. SACHS. These are policies that punish consumers and are progrowth in the long term. That should be clear. In Korea, nobody lives well. They have rising living standards but they work 59-hour weeks.

Representative SOLARZ. So you're arguing, in effect, that protectionsism can facilitate economic growth up to a certain point in the development of an economy and then at that point it can become counterproductive.

Mr. SACHS. I would put it differently. Import protection in the context of an overall export promotion policy can work for a long, long time to stimulate growth. And that's what those economies have achieved and I don't think that there's some dramatic turning

point where if you don't liberalize they're going to fail, except because of retaliation.

Representative SOLARZ. Let me ask you one final question.

Senator SARBANES. Why is requiring fair rules of the game retaliation? I was struck by the reference of a number of you to protectionism and I share that concern, but I have never understood why getting unfair trade practices out of the picture is "protectionism." It seems to me that's an abuse of what the proper trading rules should be, is it not?

Mr. BRYANT. Well, I——

Senator SARBANES. Just very briefly because I'm really interjecting on my colleague's time.

Mr. BRYANT. I am very strongly in favor of getting rid of unfair trading practices in other countries. When I made my point, I wanted to be sure it was understood that those practices haven't stiffened so much in the past 6 years that they can explain why we are where we are today.

Senator SARBANES. Even conceding that, there is no reason you should tolerate them, even if they are not the major cause.

Mr. BRYANT. But on Congressman Solarz' point, there's just one obvious thing that wasn't said which is tremendously important. A single country or a group of small countries can have protectionist policies and industrial policies that promote their own growth. All countries can't do it simultaneously. The exports of the Koreas and Brazils went to North America, Europe, and Japan. Without that export demand, those policies wouldn't have worked.

So if all the big countries try to do it, we clearly would have a mess.

Representative SOLARZ. If I may ask one final question. We're about to debate and vote on the so-called Gephardt amendment over in the House this week, which has occasioned a good deal of controversy and concern. Most economists seem to feel it's counterproductive.

I wonder, however, to paraphrase Shakespeare, if it couldn't be said that the Gephardt amendment is but a poor player that struts and frets its hour upon the stage and is heard no more. It is a tale told by an idiot, full of sound and fury, signifying nothing.

I say that in the sense that there are two waivers built into it. It is virtually inconceivable that the President would ever actually impose the requirements of the Gephardt amendment. And if the President were inclined to impose the requirements of the Gephardt amendment, it strikes me that even without the Gephardt amendment a President inclined to retaliate against some of our trading partners, where we have excessive trade deficits, where he believes they have unfair trading practices, has ample authority in existing law to do so anyway.

So in that sense, it's not clear to me what all the shouting is all about. It seems to me the amendment actually would result in very little and what little it did result, if it resulted in anything, the President could do without it.

Mr. SACHS. I think it's a disaster, the amendment. It is just a message at this point, but it is precisely the wrong message both to the American people and to the rest of the world.

The message to the American people fundamentally is that our problems are caused by others. And for a serious leader of the world where we have lived in a dream for several years, this is exactly the wrong kind of education for our people.

Representative SOLARZ. Well, you're talking about symbols. I'm talking about substance.

Mr. SACHS. But I thought your point was that it really signifies nothing. So I'm saying that if it's just a symbol, it's the wrong one.

Representative SOLARZ. Well, that case can be made. But what I'm asking you, there are also political imperatives that are involved here. One could even make a sophisticated argument that, given the protectionist pressures that are developing in the economy, one way of dealing with them is to come forward with legislation that appears to satisfy the demand for protectionism, but which really doesn't, lest you get legislation which actually requires it.

Gephardt with the waiver is very different than Gephardt without a waiver. What I'm asking you is, on substantive grounds, do you see any problems with Gephardt as opposed to what you see as the symbolic disadvantages of it?

Mr. SACHS. If it were actually to be implemented, I think it would be a disaster.

Representative SOLARZ. But my point is, does it have to be implemented and it probably wouldn't be implemented because of the waivers which are very—do you know there are waivers?

Mr. SACHS. Yes, of course.

Representative SOLARZ. And they are very broad.

Mr. SACHS. Right. But what I think that it then——

Representative SOLARZ. Can you imagine this President involving the Gephardt amendment?

Mr. SACHS. I can imagine this or the next one doing it and what I——

Senator PROXMIRE. Especially if the next one is Gephardt.

Representative SOLARZ. Yes, except—I take my good friend's point—except that even without the Gephardt amendment, if you had President Gephardt, isn't there ample authority in existing law for him to do, in effect, what the amendment would call upon him to do?

Mr. SACHS. I may be mistaken, but it seems to me that it would add to the momentum rather than deflect the momentum. And what it adds to is exactly a wrong-headed appreciation of the present situation and in that regard I think someone has to start telling the American people something about what has been going on and where the responsibilities lie. And this one seems to me to be demonology of the worst sort.

Senator SARBANES. Senator Proxmire.

Senator PROXMIRE [presiding]. Thank you very much, Mr. Chairman. I'd like to follow up what Congressman Solarz and the chairman of the committee have been pressing.

The question is, why should we not use our great advantage with respect to the Japanese in view of the fact that the adverse balance of trade we suffer is such an enormously favorable balance for them? Why shouldn't we insist that they simply comply with fair standards and reciprocity? If we're going to let their automobiles

and radios and so forth into this country, why shouldn't we insist that, as a condition of their coming in, we should be able to trade with them? What's wrong with that?

Mr. MARRIS. It's the wrong subject. The problem, as we've been discussing——

Senator PROXMIRE. Mr. Marris, let me just interrupt. You say it's the wrong subject. Do you dispute the fact that we cannot trade freely in Japan, we cannot sell our agricultural as well as other commodities in Japan?

Mr. MARRIS. Well, my institute has made a rather detailed study of the trade restrictions applied by Japan and, on the other hand, the trade restrictions applied by the United States against Japan, and their estimate is that the total removal of both would perhaps improve the U.S. trade balance by about $8 billion, whereas we're talking about a $150 billion deficit.

Senator PROXMIRE. Mr. Marris, you may be completely right. We don't know, but I think you may be completely right. Why, in that event, don't they approve them then? After all, that's a very small price to pay when they have a $50 billion favorable balance of trade. It's only $8 billion. Why not insist on that?

Mr. MARRIS. One simple answer—politics. I mean, just the same reason that you have large-scale protection in various parts of your industry, they have considerable protection of their agriculture. The Liberal Democratic Party is elected by majorities in rural constituencies.

Senator PROXMIRE. Of course, I don't mean to turn up my nose at $8 billion; $8 billion here, $8 billion there, as Dirksen used to say, you've got a few dollars, eventually.

Mr. Sachs, would you like to comment on that?

Mr. SACHS. I think that we are well within our right to continue to press for liberalization in Japan of those markets, but we should understand that we impose very significant restrictions ourselves and that that issue is really not the central one for our international relations with them. But there is no reason why not to do it. Let's do it in the context of multilateral trade negotiations, though. That's how we're going to preserve the multilateral trading system rather than by throwing our weight around when we are as guilty of import restrictions as the Japanese are.

Senator PROXMIRE. I would certainly challenge that last point. Did you want to comment, Mr. Marris?

Mr. MARRIS. Yes. I just wanted to follow up. I mean, the people who suffer most from Japanese protectionist measures, which obviously are particularly important in agriculture but also in other areas, are the Japanese consumers. It's very, very much in Japan's own interest that it should open up its economy. Its people would be much better off.

Why I said it's the wrong subject is this. That ultimately is their business. What is not their business is if they choose not to open up their economy and if they also choose to have an undervalued exchange rate—as they have through most of the postwar period—which leads to excessively large surpluses which the rest of the world simply cannot digest, that is not just their business; it's our business. And there, we have a legitimate cause to insist that they change their macroeconomic policies.

Senator PROXMIRE. Mr. Marris, 2 or 3 years ago you made a fine statement which I see you have repeated here in your presentation.

It seems to me—and I'd like each of you gentlemen to comment on this briefly—it seems to me that the biggest economic factor in the free world and free world trade is the United States. Our economy is much bigger than theirs. It seems to me that our enormous fiscal deficit has a profound effect and it is coinciding with a very expansionary monetary policy, as Mr. Sachs pointed out a minute ago. You put those two factors together, and it seems to me we're on very, very weak ground in trying to call on other countries to compensate for our enormous irresponsibility and delinquency. After all, the most threatening element now, it seems to me, is the terrible prospect of a very serious inflation. We've pumped a colossal amount of liquidity into the economy in the last 18 months, on top of this huge deficit we have been running.

Under those circumstances, how can we expect people who are responsible in Japan and Germany to say, "Well, we're going to follow suit. We're going to run deficits, too, to stimulate our economy and increase our consumption because you are asking us to do that." Is there any logic in that?

Mr. Bryant, would you like to comment?

Mr. BRYANT. Well, let me start a discussion of that, Senator Proxmire.

I think we need to take many actions here of the sort you have suggested, although I am not convinced, as you are, that the strong increase in liquidity in the last year is all inflationary. But the most important point I think we ought to remember is that both the United States and foreign governments need to take complementary actions.

Imagine that foreign governments did nothing and we did manage to take stringent measures to reduce our budget deficit. Suppose the Federal Reserve were pretty restrictive in its monetary policy. What would be the consequences of that?

We would push the U.S. economy downward relative to the path that we would have been on and the contractionary forces abroad would be still greater. Also, we would probably get still more depreciation of the dollar in the absence of expansionary measures abroad. That doesn't sound like a world economy that we should want.

Senator PROXMIRE. Let me just interrupt, I just want to point out that there's absolutely no chance of that, unfortunately. No way. Mr. Marris says wouldn't it be great if we could get the deficit down $40 billion. The administration says it's going to go down $50 billion. They say the deficit is going to drop from $221 to $174 billion or so—$171 billion. That's a $50 billion cut. It's not going to happen.

Meanwhile, or course, the Federal Reserve Board is following this enormously expansionary monetary policy and because they slowed it a week or two, the head of the Office of Management and Budget is complaining about it and you can be sure, if we get any slowdown in the economy, that Congress is going to chime in. The problem is putting on the brakes. It's going to be the hardest thing in the world.

Mr. BRYANT. Well, I realize, of course, that the hypothetical set of cooperative policies I was imagining won't occur, but my point was that to get an acceptable evolution of the world economy, we need cooperative action by both the U.S. Government and foreign governments. Furthermore, such action could be reinforced politically. The foreign governments don't want to take their actions without knowledge that we would do what we need to do here and vice versa. We certainly should not take the stringent restrictive action with monetary policy in the United States that you apparently would like if the rest of the world economy fails to grow vigorously; because if we did take such action, then we would have real trouble in the world economy.

I would like to see balanced action here and abroad and that's the potential for this consultation and cooperation and meetings like the summit meeting.

Senator PROXMIRE. You're a brave man and you're an optimistic man and you're a good man, and so you're kind of a happy man. [Laughter.]

Unfortunately, I think you're also wrong. I don't think we're going to do anything about it.

Mr. MARRIS. You may be right. It seems to be a day for Shakespeare. To come to your point, it really has been a comedy of errors. If you go back to 1981, the U.S. President, whether he knew it or not, decided that the right way of getting out of the recession was to run large budget deficits. The Governments of Germany, Japan, the United Kingdom, decided the right way to get out of the recession was to cut budget deficits.

Now if the United States had done the same thing as the other countries, we would never have had a recovery. If the other countries had done the same thing as the United States, we would have had a rip-roaring inflation in the world.

Because both of them went off on exaggerated opposite courses, the whole thing could sort of go along for a while. It was fine here. You had a big budget deficit but you didn't have too much inflation or rising interest rates because you had the dollar going up and all this foreign money pouring in. It was fine for Germany and Japan. They could practice fiscal responsibility and enjoy the stimulus they were getting from U.S. fiscal irresponsibility. It was a wonderful fool's paradise.

Now, as I said, the chickens are coming home to roost. But I would insist that, although, as my colleagues have insisted, the one essential piece in a solution is real action on the U.S. budget deficit—and I entirely agree with your skepticism about that—because of where we have now got to, the other essential piece will have to be fiscal expansion in the other countries—and I'm just about as skeptical as to whether we are going to get that.

So I am feeling extremely pessimistic about the outlook.

Senator PROXMIRE. Gentlemen, thank you very, very much. I apologize. As you know, both the Senate and the House are involved in very hectic action on the floor and elsewhere. I want to thank you very, very much for a fine presentation. We so much appreciate your coming.

The committee will stand adjourned.

[Whereupon, at 11:15 a.m., the committee adjourned, subject to the call of the Chair.]

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